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code of federal regulations

Internal Revenue

ORIGINAL

COMPLETED

26

PART 1 (§§ 1.0–1 TO 1.169)

Revised as of April 1, 1981

022-003-94595-4

code of federal regulations

Internal Revenue

26

PART 1 (§§ 1.0–1 TO 1.169)

Revised as of April 1, 1981

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Cite this Code **CFR**

thus: **26 CFR 1.0–1**

Explanation

The Code of Federal Regulations is a codification of the general and permanent rules published in the Federal Register by the Executive departments and agencies of the Federal Government. The Code is divided into 50 titles which represent broad areas subject to Federal regulation. Each title is divided into chapters which usually bear the name of the issuing agency. Each chapter is further subdivided into parts covering specific regulatory areas.

ISSUE DATES

Each volume of the Code is revised at least once each calendar year and issued on a quarterly basis approximately as follows:

Title 1 through Title 16..... as of January 1
Title 17 through Title 27.....as of April 1
Title 28 through Title 41..... as of July 1
Title 42 through Title 50..... as of October 1

The appropriate revision date is printed on the cover of each volume.

LEGAL STATUS

The contents of the Federal Register are required to be judicially noticed (44 U.S.C. 1507). The Code of Federal Regulations is prima facie evidence of the text of the original documents (44 U.S.C. 1510).

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The Code of Federal Regulations is kept up to date by the individual issues of the Federal Register. These two publications must be used together to determine the latest version of any given rule.

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Each volume of the Code contains amendments published in the Federal Register since the last revision of that volume of the Code. Source citations for the regulations are referred to by volume number and page number of the Federal Register and date of publication. Publication dates and effective dates are usually not the same and care must be exercised by the user in determining the actual effective date. In instances where the effective date is beyond the cut-off date for the Code a note has been inserted to reflect the future effective date.

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JOHN E. BYRNE,
Director,
Office of the Federal Register.

April 1, 1981.

THIS TITLE

Title 26—INTERNAL REVENUE is composed of fourteen volumes. The contents of these volumes represent all current regulations issued by the Internal Revenue Service, Department of the Treasury, as of April 1, 1981. The first eight volumes comprise Part 1 (Subchapter A—Income Tax) and are arranged by sections as follows: §§ 1.0–1.169; §§ 1.170–1.300; §§ 1.301–1.400; §§ 1.401–1.500; §§ 1.501–1.640; §§ 1.641–1.850; §§ 1.851–1.1200 and § 1.1201 to end. The ninth volume containing Parts 2–29, includes the remainder of Subchapter A and all of Subchapter B—Estate and Gift Taxes. The last five volumes contain as follows: Parts 30–39 (Subchapter C—Employment Taxes); Parts 40–299 (Subchapter D—Miscellaneous Excise Taxes); Parts 300–499 (Subchapter F—Procedure and Administration); Parts 500–599 (Subchapter G—Regulations under Tax Conventions); and Part 600 to end (Subchapter H—Internal Revenue Practice).

For this volume Mildred L. Isler was Chief Editor. The *Code of Federal Regulations* publications program is under the direction of Martha B. Girard, assisted by Robert E. Jordan.

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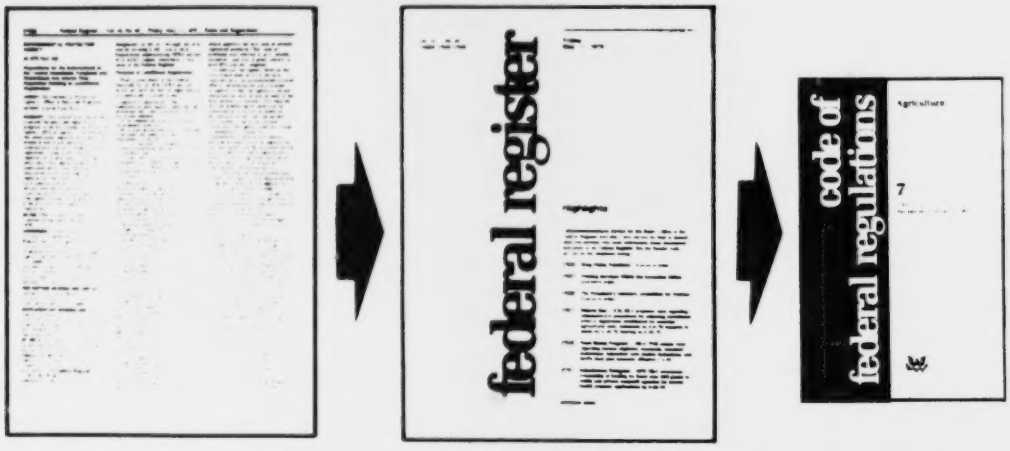

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Title 26—Internal Revenue

(This book contains Part 1, §§ 1.0-1 to 1.169)

Part

CHAPTER I—Internal Revenue Service, Department of the Treasury 1

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CHAPTER I—INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY

(Part 1, §§ 1.0-1 to 1.169)

NOTE: IRS published a document at 45 FR 6088, Jan. 25, 1980, deleting statutory sections from their regulations. In Chapter I cross references to the deleted material have been changed to the corresponding sections of the IRS Code of 1954 or to the appropriate regulations sections. When either such change produced a redundancy, the cross reference has been deleted. For further explanation, see 45 FR 20795, March 31, 1980.

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Supplementary Publication: *Internal Revenue Service Looseleaf Regulations System.*

Additional supplementary publications are issued covering *Alcohol and Tobacco Tax Regulations,* and *Regulations Under Tax Conventions.*

NOTE: Treasury Decision 6091, 19 FR 5167, Aug. 17, 1954, provides in part as follows:

PARAGRAPH 1. All regulations (including all Treasury decisions) prescribed by, or under authority duly delegated by, the Secretary of the Treasury, or jointly by the Secretary and the Commissioner of Internal Revenue, or by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury, or jointly by the Commissioner of Internal Revenue and the Commissioner of Customs or the Commissioner of Narcotics with the approval of the Secretary of the Treasury, applicable under any provision of law in effect on the date of enactment of the Code, to the extent such provision of law is repealed by the Code, are hereby prescribed under and made applicable to the provisions of the Code corresponding to the provision of law so repealed insofar as any such regulation is not inconsistent with the Code. Such regulations shall become effective as regulations under the various provisions of the Code as of the dates the corresponding provisions of law are repealed by the Code, until superseded by regulations issued under the Code.

PAR. 2. With respect to any provision of the Code which depends for its application upon the promulgation of regulations or which is to be applied in such manner as may be prescribed by regulations, all instructions or rules in effect immediately prior to the enactment of the Code, to the extent such instructions or rules could be prescribed as regulations under authority of such provision of the Code, shall be applied as regulations under such provision insofar as such instructions or rules are not inconsistent with the Code. Such instructions or rules shall be applied as regulations under the applicable provision of the Code as of the date such provision takes effect.

PAR. 3. If any election made or other act done pursuant to any provision of the Internal Revenue Code of 1939 or prior internal revenue laws would (except for the enactment of the Code) be effective for any period subsequent to such enactment, and if corresponding provisions are contained in the Code, such election or other act shall be given the same effect under the corresponding provisions of the Code to the extent not inconsistent therewith. The term "act" includes, but is not limited to, an allocation, identification, declaration, agreement, option, waiver, relinquishment, or renunciation.

PAR. 4. The limits of the various internal revenue districts have not been changed by the enactment of the Code. Furthermore, delegations of authority made pursuant to the provisions of Reorganization Plan No. 26 of 1950 and Reorganization Plan No. 1 of 1952 (as well as redelegations thereunder), including those governing the authority of the Commissioner of Internal Revenue, the Regional Commissioners of Internal Revenue, or the District Directors of Internal Revenue, are applicable to the provisions of the Code to the extent consistent therewith.

SUBCHAPTER A—INCOME TAX

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AUTHORITY: Sec. 7805, 68A Stat. 917 (26 U.S.C. 7805), unless otherwise noted. Sections 1.50A to 1.50B issued also under 85 Stat. 553 (26 U.S.C. 40(b)).

SOURCE: T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, unless otherwise noted.

§ 1.0–1 Internal Revenue Code of 1954 and regulations.

(a) *Enactment of law.* The Internal Revenue Code of 1954 which became law upon enactment of Public Law 591, 83d Congress, approved August 16, 1954, provides in part as follows:

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) *Citation.* (1) The provisions of this Act set forth under the heading "Internal Revenue Title" may be cited as the "Internal Revenue Code of 1954"

(2) The Internal Revenue Code enacted on February 10, 1939, as amended, may be cited as the "Internal Revenue Code of 1939".

(b) *Publication.* This Act shall be published as volume 68A of the United States Statutes at Large, with a comprehensive table of contents and an appendix; but without an index or marginal references. The date of enactment, bill number, public law number, and chapter number, shall be printed as a headnote.

(c) *Cross reference.* For saving provisions, effective date provisions, and other related provisions, see chapter 80 (sec. 7801 and following) of the Internal Revenue Code of 1954.

(d) *Enactment of Internal Revenue Title into law.* The Internal Revenue Title referred to in subsection (a)(1) is as follows:

* * * * *

In general, the provisions of the Internal Revenue Code of 1954 are applicable with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954. Certain provisions of that Code are deemed to be included in the Internal Revenue Code of 1939. See section 7851.

(b) *Scope of regulations.* The regulations in this part deal with (1) the income taxes imposed under subtitle A of the Internal Revenue Code of 1954, and (2) certain administrative provisions contained in subtitle F of such Code relating to such taxes. In general, the applicability of such regulations is commensurate with the applicability of the respective provisions of the Internal Revenue Code of 1954 except that with respect to the provisions of the Internal Revenue Code of 1954 which are deemed to be included in the Internal Revenue Code of 1939, the regulations relating to such provisions are applicable to certain fiscal years and short taxable years which are subject to the Internal Revenue Code of 1939. Those provisions of the regulations which are applicable to taxable years subject to the Internal Revenue Code of 1939 and the specific taxable years to which such provisions are so applicable are identified in each instance. The regulations in 26 CFR (1939) Part 39 (Regulations 118) are continued in effect until superseded by the regulations in this part. See Treasury Decision 6091, approved August 16, 1954 (19 FR 5167, C.B. 1954–2, 47).

Normal Taxes and Surtaxes

DETERMINATION OF TAX LIABILITY

TAX ON INDIVIDUALS

§ 1.1–1 Income tax on individuals.

(a) *General rule.* (1) Section 1 of the Code imposes an income tax on the income of every individual who is a citizen or resident of the United States and, to the extent provided by section 871(b) or 877(b), on the income of a nonresident alien individual. For optional tax in the case of taxpayers with adjusted gross income of less than $10,000 (less than $5,000 for taxable years beginning before January 1, 1970) see section 3. The tax imposed is upon taxable income (determined by subtracting the allowable deductions from gross income). The tax is determined in accordance with the table contained in section 1. See subparagraph (2) of this paragraph for reference guides to the appropriate table for taxable years beginning on or after January 1, 1964, and before January 1, 1965, taxable years beginning after December 31, 1964, and before January 1, 1971, and taxable years beginning after December 31, 1970. In certain cases credits are allowed against the amount of the tax. See part IV (section 31 and following), subchapter A, chapter 1 of the Code. In general, the tax is payable upon the basis of returns rendered by persons liable therefor (subchapter A (sections 6001 and following), chapter 61 of the Code) or at the source of the income by withholding. For the computation of tax in the case of a joint return of a husband and wife, or a return of a surviving spouse, for taxable years beginning before January 1, 1971, see section 2. The computation of tax in such a case for taxable years beginning after December 31, 1970, is determined in accordance with the table contained in section 1(a) as amended by the Tax Reform Act of 1969. For other rates of tax on individuals, see section 5(a). For the imposition of an additional tax for the calendar years 1968, 1969, and 1970, see section 51(a).

(2) (i) For taxable years beginning on or after January 1, 1964, the tax imposed upon a single individual, a head of a household, a married individual filing a separate return, and estates and trusts is the tax imposed by section 1 determined in accordance with the appropriate table contained in the following subsection of section 1:

	Taxable years beginning in 1964	Taxable years beginning after 1964 but before 1971	Taxable years beginning after Dec. 31, 1970 (references in this column are to the Code as amended by the Tax Reform Act of 1969)
Single individual	Sec. 1(a)(1)	Sec. 1(a)(2)	Sec. 1(c).
Head of a household	Sec. 1(b)(1)	Sec. 1(b)(2)	Sec. 1(b).
Married individual filing a separate return	Sec. 1(a)(1)	Sec. 1(a)(2)	Sec. 1(d).
Estates and trusts	Sec. 1(a)(1)	Sec. 1(a)(2)	Sec. 1(d).

(ii) For taxable years beginning after December 31, 1970, the tax imposed by section 1(d), as amended by the Tax Reform Act of 1969, shall apply to the income effectively connected with the conduct of a trade or business in the United States by a married alien individual who is a nonresident of the United States for all or part of the taxable year or by a foreign estate or trust. For such years the tax imposed by section 1(c), as amended by such Act, shall apply to the income effectively connected with the conduct of a trade or business in the United States by an unmarried alien individual (other than a surviving spouse) who is a nonresident of the United States for all or part of the taxable year. See paragraph (b)(2) of § 1.871–8.

(3) The income tax imposed by section 1 upon any amount of taxable income is computed by adding to the income tax for the bracket in which that amount falls in the appropriate table in section 1 the income tax upon the excess of that amount over the bottom of the bracket at the rate indicated in such table.

(4) The provisions of section 1 of the Code, as amended by the Tax Reform Act of 1969, and of this paragraph

may be illustrated by the following examples:

Example (1). A, an unmarried individual, had taxable income for the calendar year 1964 of $15,750. Accordingly, the tax upon such taxable income would be $4,507.50, computed as follows from the table in section 1(a)(1):

Tax on $14,000 (from table)	$3,790.00
Tax on $1,750 (at 41 percent as determined from the table)	717.50
Total tax on $15,750	4,507.50

Example (2). Assume the same facts as in example (1), except the figures are for the calendar year 1965. The tax upon such taxable income would be $4,232.50, computed as follows from the table in section 1(a)(2):

Tax on $14,000 (from table)	$3,550.00
Tax on $1,750 (at 39 percent as determined from the table)	682.50
Total tax on $15,750	4,232.50

Example (3). Assume the same facts as in example (1), except the figures are for the calendar year 1971. The tax upon such taxable income would be $3,752.50, computed as follows from the table in section 1(c), as amended:

Tax on $14,000 (from table)	$3,210.00
Tax on $1,750 (at 31 percent as determined from the table)	542.50
Total tax on $15,750	3,752.50

(b) *Citizens or residents of the United States liable to tax.* In general, all citizens of the United States, wherever resident, and all resident alien individuals are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States. Pursuant to section 876, a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year is, except as provided in section 933 with respect to Puerto Rican source income, subject to taxation in the same manner as a resident alien individual. As to tax on nonresident alien individuals, see sections 871 and 877.

(c) *Who is a citizen.* Every person born or naturalized in the United States and subject to its jurisdiction is a citizen. For other rules governing the acquisition of citizenship, see chapters 1 and 2 of title III of the Immigration and Nationality Act (8 U.S.C. 1401-1459). For rules governing loss of citizenship, see sections 349 to 357, inclusive, of such Act (8 U.S.C. 1481-1489), Schneider v. Rusk, (1964) 377 U.S. 163, and Rev. Rul. 70-506, C.B. 1970-2, 1. For rules pertaining to persons who are nationals but not citizens at birth, e.g., a person born in American Samoa, see section 308 of such Act (8 U.S.C. 1408). For special rules applicable to certain expatriates who have lost citizenship with a principal purpose of avoiding certain taxes, see section 877. A foreigner who has filed his declaration of intention of becoming a citizen but who has not yet been admitted to citizenship by a final order of a naturalization court is an alien.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7332, 39 FR 44216, Dec. 23, 1974]

§ 1.1-2 Limitation on tax.

(a) *Taxable years ending before January 1, 1971.* For taxable years ending before January 1, 1971, the tax imposed by section 1 (whether by subsection (a) or subsection (b) thereof) shall not exceed 87 percent of the taxable income for the taxable year. For purposes of determining this limitation the tax under section 1 (a) or (b) and the tax at the 87-percent rate shall each be computed before the allowance of any credits against the tax. Where the alternative tax on capital gains is imposed under section 1201(b), the 87-percent limitation shall apply only to the partial tax computed on the taxable income reduced by 50 percent of the excess of net long-term capital gains over net short-term capital losses. Where, for purposes of computations under the income averaging provisions, section 1201(b) is treated as imposing the alternative tax on capital gains computed under section 1304(e)(2), the 87-percent limitation shall apply only to the tax equal to the tax imposed by section 1, reduced by the amount of the tax imposed by section 1 which is attributable to capital gain net income for the computation year.

(b) *Taxable years beginning after December 31, 1970.* If, for any taxable year beginning after December 31,

1970, an individual has earned taxable income which exceeds his taxable income as defined by section 1348, the tax imposed by section 1, as amended by the Tax Reform Act of 1969, shall not exceed the sum computed under the provisions of section 1348. For imposition of minimum tax for tax preferences see sections 56 through 58.

[T.D. 7117, 36 FR 9397, May 25, 1971]

§ 1.1-3 Change in rates applicable to taxable year.

For computation of the tax for a taxable year during which a change in the tax rates occurs, see section 21 and the regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960. Redesignated by T.D. 7117, 36 FR 9397, May 25, 1971]

§ 1.2-1 Tax in case of joint return of husband and wife or the return of a surviving spouse.

(a) *Taxable year ending before January 1, 1971.* (1) For taxable years ending before January 1, 1971, in the case of a joint return of husband and wife, or the return of a surviving spouse as defined in section 2(b), the tax imposed by section 1 shall be twice the tax that would be imposed if the taxable income were reduced by one-half. For rules relating to the filing of joint returns of husband and wife, see section 6013 and the regulations thereunder.

(2) The method of computing, under section 2(a), the tax of husband and wife in the case of a joint return, or the tax of a surviving spouse, is as follows:

(i) First, the taxable income is reduced by one-half. Second, the tax is determined as provided by section 1 by using the taxable income so reduced. Third, the tax so determined, which is the tax that would be determined if the taxable income were reduced by one-half, is then multiplied by two to produce the tax imposed in the case of the joint return or the return of a surviving spouse, subject, however, to the allowance of any credits against the tax under the provisions of sections 31 through 38 and the regulations thereunder.

(ii) The limitation under section 1(c) of the tax to an amount not in excess of a specified percent of the taxable income for the taxable year is to be applied before the third step above, that is, the limitation to be applied upon the tax is determined as the applicable specified percent of one-half of the taxable income for the taxable year (such one-half of the taxable income being the actual aggregate taxable income of the spouses, or the total taxable income of the surviving spouse, as the case may be, reduced by one-half). For the percent applicable in determining the limitation of the tax under section 1(c), see § 1.1-2(a). After such limitation is applied, then the tax so limited is multiplied by two as provided in section 2(a) (the third step above).

(iii) The following computation illustrates the method of application of section 2(a) in the determination of the tax of a husband and wife filing a joint return for the calendar year 1965. If the combined gross income is $8,200, and the only deductions are the two exemptions of the taxpayers under section 151(b) and the standard deduction under section 141, the tax on the joint return for 1965, without regard to any credits against the tax, is $1,034.20 determined as follows:

1. Gross income		$8,200.00
2. Less:		
Standard deduction, section 141	$820	
Deduction for personal exemption, section 151	1,200	2,020.00
3. Taxable income		6,180.00
4. Taxable income reduced by one-half		3,090.00
5. Tax computed by the tax table provided under section 1(a) (2) ($310 plus 19 percent of excess over $2,000)		517.10
6. Twice the tax in item 5		1,034.20

(b) *Taxable years beginning after December 31, 1970.* (1) For taxable years beginning after December 31, 1970, in the case of a joint return of husband and wife, or the return of a surviving spouse as defined in section 2(a) of the Code as amended by the Tax Reform Act of 1969, the tax shall be determined in accordance with the table contained in section 1(a) of the Code as so amended. For rules relating to the filing of joint returns of husband

and wife see section 6013 as amended and the regulations thereunder.

(2) The following computation illustrates the method of computing the tax of a husband and wife filing a joint return for calendar year 1971. If the combined gross income is $8,200, and the only deductions are the two exemptions of the taxpayers under section 151(b), as amended, and the standard deduction under section 141, as amended, the tax on the joint return for 1971, without regard to any credits against the tax, is $968.46, determined as follows:

1. Gross income		$8,200.00
2. Less:		
Standard deduction, section 141	$1,066.00	
Deduction for personal exemption, section 151	1,300.00	2,366.00
3. Taxable income		5,834.00
4. Tax computed by the tax table provided under section 1(a) ($620 plus 19 percent of excess over $4,000)		968.46

(3) The limitation under section 1348 with respect to the maximum rate of tax on earned income shall apply to a married individual only if such individual and his spouse file a joint return for the taxable year.

(c) *Death of a spouse.* If a joint return of a husband and wife is filed under the provisions of section 6013 and if the husband and wife have different taxable years solely because of the death of either spouse, the taxable year of the deceased spouse covered by the joint return shall, for the purpose of the computation of the tax in respect of such joint return, be deemed to have ended on the date of the closing of the surviving spouse's taxable year.

(d) *Computation of optional tax.* For computation of optional tax in the case of a joint return or the return of a surviving spouse, see section 3 and the regulations thereunder.

(e) *Change in rates.* For treatment of taxable years during which a change in the tax rates occurs see section 21 and the regulations thereunder.

[T.D. 7117, 36 FR 9398, May 25, 1971]

§ 1.2-2 Definitions and special rules.

(a) *Surviving spouse.* (1) If a taxpayer is eligible to file a joint return under the Internal Revenue Code of 1954 without regard to section 6013(a)(3) thereof for the taxable year in which his spouse dies, his return for each of the next 2 taxable years following the year of the death of the spouse shall be treated as a joint return for all purposes if all three of the following requirements are satisfied:

(i) He has not remarried before the close of the taxable year the return for which is sought to be treated as a joint return, and

(ii) He maintains as his home a household which constitutes for the taxable year the principal place of abode as a member of such household of a person who is (whether by blood or adoption) a son, stepson, daughter, or stepdaughter of the taxpayer, and

(iii) He is entitled for the taxable year to a deduction under section 151 (relating to deductions for dependents) with respect to such son, stepson, daughter, or stepdaughter.

(2) See paragraphs (c)(1) and (d) of this section for rules for the determination of when the taxpayer maintains as his home a household which constitutes for the taxable year the principal place of abode, as a member of such household, of another person.

(3) If the taxpayer does not qualify as a surviving spouse he may nevertheless qualify as a head of a household if he meets the requirements of § 1.2-2(b).

(4) The following example illustrates the provisions relating to a surviving spouse:

Example: Assume that the taxpayer meets the requirements of this paragraph for the years 1967 through 1971, and that the taxpayer, whose wife died during 1966 while married to him, remarried in 1968. In 1969, the taxpayer's second wife died while married to him, and he remained single thereafter. For 1967 the taxpayer will qualify as a surviving spouse, provided that neither the taxpayer nor the first wife was a nonresident alien at any time during 1966 and that she (immediately prior to her death) did not have a taxable year different from that of the taxpayer. For 1968 the taxpayer does not qualify as a surviving spouse because he remarried before the close of the taxable year. The taxpayer will qualify as a surviving spouse for 1970 and 1971, provided that neither the taxpayer nor the second wife

was a nonresident alien at any time during 1969 and that she (immediately prior to her death) did not have a taxable year different from that of the taxpayer. On the other hand, if the taxpayer, in 1969, was divorced or legally separated from his second wife, the taxpayer will not qualify as a surviving spouse for 1970 or 1971, since he could not have filed a joint return for 1969 (the year in which his second wife died).

(b) *Head of household.* (1) A taxpayer shall be considered the head of a household if, and only if, he is not married at the close of his taxable year, is not a surviving spouse (as defined in paragraph (a) of this section, and (i) maintains as his home a household which constitutes for such taxable year the principal place of abode, as a member of such household, of at least one of the individuals described in subparagraph (3), or (ii) maintains (whether or not as his home) a household which constitutes for such taxable year the principal place of abode of one of the individuals described in subparagraph (4).

(2) Under no circumstances shall the same person be used to qualify more than one taxpayer as the head of a household for the same taxable year.

(3) Any of the following persons may qualify the taxpayer as a head of a household:

(i) A son, stepson, daughter, or stepdaughter of the taxpayer, or a descendant of a son or daughter of the taxpayer. For the purpose of determining whether any of the stated relationships exist, a legally adopted child of a person is considered a child of such person by blood. If any such person is not married at the close of the taxable year of the taxpayer, the taxpayer may qualify as the head of a household by reason of such person even though the taxpayer may not claim a deduction for such person under section 151, for example, because the taxpayer does not furnish more than half of the support of such person. However, if any such person is married at the close of the taxable year of the taxpayer, the taxpayer may qualify as the head of a household by reason of such person only if the taxpayer is entitled to a deduction for such person under section 151 and the regulations thereunder. In applying the preceding sentence there shall be disregarded any such person for whom a deduction is allowed under section 151 only by reason of section 152(c) (relating to persons covered by a multiple support agreement).

(ii) Any other person who is a dependent of the taxpayer, if the taxpayer is entitled to a deduction for the taxable year for such person under section 151 and paragraphs (3) through (8) of section 152(a) and the regulations thereunder. Under section 151 the taxpayer may be entitled to a deduction for any of the following persons:

(*a*) His brother, sister, stepbrother, or stepsister;

(*b*) His father or mother, or an ancestor of either;

(*c*) His stepfather or stepmother;

(*d*) A son or a daughter of his brother or sister;

(*e*) A brother or sister of his father or mother; or

(*f*) His son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law,or sister-in-law;

if such person has a gross income of less than the amount determined pursuant to § 1.151-2 applicable to the calendar year in which the taxable year of the taxpayer begins, if the taxpayer supplies more than one-half of the support of such person for such calendar year and if such person does not make a joint return with his spouse for the taxable year beginning in such calendar year. The taxpayer may not be considered to be a head of a household by reason of any person for whom a deduction is allowed under section 151 only by reason of sections 152(a) (9), 152(a) (10), or 152(c) (relating to persons not related to the taxpayer, persons receiving institutional care, and persons covered by multiple support agreements).

(4) The father or mother of the taxpayer may qualify the taxpayer as a head of a household, but only if the taxpayer is entitled to a deduction for the taxable year for such father or mother under section 151 (determined without regard to section 152(c)). For example, an unmarried taxpayer who maintains a home for his widowed mother may not qualify as the head of a household by reason of his mainte-

nance of a home for his mother if his mother has gross income equal to or in excess of the amount determined pursuant to § 1.151-2 applicable to the calendar year in which the taxable year of the taxpayer begins, or if he does not furnish more than one-half of the support of his mother for such calendar year. For this purpose, a person who legally adopted the taxpayer is considered the father or mother of the taxpayer.

(5) For the purpose of this paragraph, the status of the taxpayer shall be determined as of the close of the taxpayer's taxable year. A taxpayer shall be considered as not married if at the close of his taxable year he is legally separated from his spouse under a decree of divorce or separate maintenance, or if at any time during the taxable year the spouse to whom the taxpayer is married at the close of his taxable year was a nonresident alien. A taxpayer shall be considered married at the close of his taxable year if his spouse (other than a spouse who is a nonresident alien) dies during such year.

(6) If the taxpayer is a nonresident alien during any part of the taxable year he may not qualify as a head of a household even though he may comply with the other provisions of this paragraph. See the regulations prescribed under section 871 for a definition of nonresident alien.

(c) *Household.* (1) In order for a taxpayer to be considered as maintaining a household by reason of any individual described in paragraph (a)(1) or (b)(3) of this section, the household must actually constitute the home of the taxpayer for his taxable year. A physical change in the location of such home will not prevent a taxpayer from qualifying as a head of a household. Such home must also constitute the principal place of abode of at least one of the persons specified in such paragraph (a)(1) or (b)(3) of this section. It is not sufficient that the taxpayer maintain the household without being its occupant. The taxpayer and such other person must occupy the household for the entire taxable year of the taxpayer. However, the fact that such other person is born or dies within the taxable year will not prevent the taxpayer from qualifying as a head of household if the household constitutes the principal place of abode of such other person for the remaining or preceding part of such taxable year. The taxpayer and such other person will be considered as occupying the household for such entire taxable year notwithstanding temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which a child or stepchild is absent for less than 6 months in the taxable year of the taxpayer, shall be considered temporary absence due to special circumstances. Such absence will not prevent the taxpayer from being considered as maintaining a household if (i) it is reasonable to assume that the taxpayer or such other person will return to the household, and (ii) the taxpayer continues to maintain such household or a substantially equivalent household in anticipation of such return.

(2) In order for a taxpayer to be considered as maintaining a household by reason of any individual described in paragraph (b)(4) of this section, the household must actually constitute the principal place of abode of the taxpayer's dependent father or mother, or both of them. It is not, however, necessary for the purposes of such subparagraph for the taxpayer also to reside in such place of abode. A physical change in the location of such home will not prevent a taxpayer from qualifying as a head of a household. The father or mother of the taxpayer, however, must occupy the household for the entire taxable year of the taxpayer. They will be considered as occupying the household for such entire year notwithstanding temporary absences from the household due to special circumstances. For example, a nonpermanent failure to occupy the household by reason of illness or vacation shall be considered temporary absence due to special circumstances. Such absence will not prevent the taxpayer from qualifying as the head of a household if (i) it is reasonable to assume that such person will return to the household, and (ii)

the taxpayer continues to maintain such household or a substantially equivalent household in anticipation of such return. However, the fact that the father or mother of the taxpayer dies within the year will not prevent the taxpayer from qualifying as a head of a household if the household constitutes the principal place of abode of the father or mother for the preceding part of such taxable year.

(d) *Cost of maintaining a household.* A taxpayer shall be considered as maintaining a household only if he pays more than one-half the cost thereof for his taxable year. The cost of maintaining a household shall be the expenses incurred for the mutual benefit of the occupants thereof by reason of its operation as the principal place of abode of such occupants for such taxable year. The cost of maintaining a household shall not include expenses otherwise incurred. The expenses of maintaining a household include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises. Such expenses do not include the cost of clothing, education, medical treatment, vacations, life insurance, and transportation. In addition, the cost of maintaining a household shall not include any amount which represents the value of services rendered in the household by the taxpayer or by a person qualifying the taxpayer as a head of a household or as a surviving spouse.

(e) *Certain married individuals living apart.* For taxable years beginning after December 31, 1969, an individual who is considered as not married under section 143(b) shall be considered as not married for purposes of determining whether he or she qualifies as a single individual, a married individual, a head of household or a surviving spouse under sections 1 and 2 of the Code.

[T.D. 7117, 36 FR 9398, May 25, 1971]

§ 1.3–1 Application of optional tax.

(a) *General rules.* (1) For taxable years ending before January 1, 1970, an individual whose adjusted gross income is less than $5,000 (or a husband and wife filing a joint return whose combined adjusted gross income is less than $5,000) may elect to pay the tax imposed by section 3 in place of the tax imposed by section 1 (a) or (b). For taxable years beginning after December 31, 1969 and before January 1, 1971 an individual whose adjusted gross income is less than $10,000 (or a husband and wife filing a joint return whose combined adjusted gross income is less than $10,000) may elect to pay the tax imposed by section 3 as amended by the Tax Reform Act of 1969 in place of the tax imposed by section 1 (a) or (b). For taxable years beginning after December 31, 1970 an individual whose adjusted gross income is less than $10,000 (or a husband and wife filing a joint return whose combined adjusted gross income is less than $10,000) may elect to pay the tax imposed by section 3 as amended in place of the tax imposed by section 1 as amended. See § 1.4–2 for the manner of making such election. A taxpayer may make such election regardless of the sources from which his income is derived and regardless of whether his income is computed by the cash method or the accrual method. See section 62 and the regulations thereunder for the determination of adjusted gross income. For the purpose of determining whether a taxpayer may elect to pay the tax under section 3, the amount of the adjusted gross income is controlling, without reference to the number of exemptions to which the taxpayer may be entitled. See section 4 and the regulations thereunder for additional rules applicable to section 3.

(2) The following examples illustrate the rule that section 3 applies only if the adjusted gross income is less than $10,000 ($5,000 for taxable years ending before January 1, 1970).

Example (1). A is employed at a salary of $9,200 for the calendar year 1970. In the course of such employment, he incurred travel expenses of $1,500 for which he was reimbursed during the year. Such items constitute his sole income for 1970. In such case the gross income is $10,700 but the amount of $1,500 is deducted from gross income in the determination of adjusted gross income and thus A's adjusted gross income for 1970 is $9,200. Hence, the adjusted gross income being less than $10,000, he may elect to pay

his tax for 1970 under section 3. Similarly, in the case of an individual engaged in trade or business (excluding from the term "engaged in trade or business" the performance of personal services as an employee), there may be deducted from gross income in ascertaining adjusted gross income those expenses directly relating to the carrying on of such trade or business.

Example (2). If B has, as his only income for 1970, a salary of $11,600 and his spouse has no gross income, then B's adjusted gross income is $11,600 (not $11,600 reduced by exemptions of $1,250) and he is not for such year, entitled to pay his tax under section 3. If, however, B has for 1970 a salary of $13,000 and incident to his employment he incurs expenses in the amount of $3,400 for travel, meals, and lodging while away from home, for which he is not reimbursed, the adjusted gross income is $13,000 minus $3,400 or $9,600. In such case his adjusted gross income being less than $10,000, B may elect to pay the tax under section 3. However, if B's wife has adjusted gross income of $400, the total adjusted gross income is $10,000. In such case, if B and his wife file a joint return, they may not elect to pay the optional tax since the combined adjusted gross income is not less than $10,000. B may nevertheless elect to pay the optional tax, but if he makes this election he must file a separate return and, since his wife has gross income, he may not claim an exemption for her in computing the optional tax.

(b) *Surviving spouse.* The return of a surviving spouse is treated as a joint return for purposes of section 3. See section 2, and the regulations thereunder, with respect to the qualifications of a taxpayer as a surviving spouse. Accordingly, if the taxpayer qualifies as a surviving spouse and elects to pay the optional tax, he shall use the column in the tax table, appropriate to his number of exemptions, provided for cases in which a joint return is filed.

(c) *Use of tax table.* (1) To determine the amount of the tax, the individual ascertains the amount of his adjusted gross income, refers to the appropriate table set forth in section 3 or the regulations thereunder, ascertains the income bracket into which such income falls, and, using the number of exemptions applicable to his case, finds the tax in the vertical column having at the top thereof a number corresponding to the number of exemptions to which the taxpayer is entitled.

(2) Section 3(b) (relating to taxable years beginning after Dec. 31, 1964 and ending before Jan. 1, 1970) contains 5 tables for use in computing the tax. Table I is to be used by a single person who is not a head of household. Table II is to be used by a head of household. Table III is to be used by married persons filing joint returns and by a surviving spouse. Table IV is to be used by married persons filing separate returns using the 10 percent standard deduction. Table V is to be used by married persons filing separate returns using the minimum standard deduction. For an explanation of the standard deduction see section 141 and the regulations thereunder.

(3) 30 tables are provided for use in computing the tax under the Tax Reform Act of 1969. Tables I through XV apply for taxable years beginning after December 31, 1969 and ending before January 1, 1971. Tables XVI through XXX apply for taxable years beginning after December 31, 1970. The standard deduction for Tables I through XV, applicable to taxable years beginning in 1970, is 10 percent. The standard deduction for Tables XVI through XXX, applicable to taxable years beginning in 1971, is 13 percent. For an explanation of the standard deduction and the low income allowance see section 141 as amended by the Tax Reform Act of 1969.

(4) In the case of married persons filing separate returns who qualify to use the optional tax imposed by section 3, such persons shall use the tax imposed by the table for the applicable year in accordance with the rules prescribed by sections 4(c) and 141 and the regulations thereunder governing the use and application of the standard deduction and the low income allowance.

(5) The tax shown in the tax tables set forth in section 3 or the regulations thereunder reflects full income splitting in the case of a joint return (including the return of a surviving spouse) and lesser income splitting in the case of a head of household. Therefore, it is possible for the tax shown in the tables relating to joint returns, or relating to a return of a head of a household, to be lower than that shown in the table for separate

returns even though the amounts of adjusted gross income and the number of exemptions are the same.

[T.D. 7117, 36 FR 9420, May 25, 1971]

§ 1.4–1 Number of exemptions.

(a) For the purpose of determining the optional tax imposed under section 3, the taxpayer shall use the number of exemptions allowable to him as deductions under section 151. See sections 151, 152, and 153, and the regulations thereunder. In general, one exemption is allowed for the taxpayer; one exemption for his spouse if a joint return is made, or if a separate return is made by the taxpayer and his spouse has no gross income for the calendar year in which the taxable year of the taxpayer begins and is not the dependent of another taxpayer for such calendar year; and one exemption for each dependent whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than the applicable amount determined pursuant to § 1.151–2. No exemption is allowed for any dependent who has made a joint return with his spouse for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins. The taxpayer may, in certain cases, be allowed an exemption for a dependent child of the taxpayer notwithstanding the fact that such child has gross income equal to or in excess of the amount determined pursuant to § 1.151–2 applicable to the calendar year in which the taxable year of the taxpayer begins. The requirements for the allowance of such an exemption are set forth in paragraph (c) of § 1.152–1. See paragraphs (c) and (d) of § 1.151–1 with respect to additional exemptions for a taxpayer or spouse who has attained the age 65 years and for a blind taxpayer or blind spouse

(b) The application of this section may be illustrated by the following examples:

Example (1). A, a married man whose duties as an employee require traveling away from his home, has as his sole gross income a salary of $5,600 for the calendar year 1954. His traveling expenses, including cost of meals and lodging, amount in such year to $750, and hence, his adjusted gross income is $4,850. His wife, B, has as her sole income interest in the amount of $85, and thus the aggregate adjusted gross income of A and B is $4,935. A has two dependent children neither of whom has any income. A and B file a joint return for 1954 on Form 1040. In such case four exemptions are allowable. The adjusted gross income falls within the tax bracket $4,900–4,950. By referring to such tax bracket in the tax table in section 3 and to the column headed "4" therein, the tax is found to be $407.

Example (2). C, a married man, has as his sole income in 1954 wages of $4,600, and has two dependent children neither of whom has any income. His wife, D, has adjusted gross income of $400. C files a separate return for 1954 and is entitled to claim three exemptions. C's income falls within the tax bracket $4,600–4,650 and hence, with three exemptions his tax is $480. No exemption is allowed with respect to since D has gross income and a joint return was not filed.

Example (3). D, a married man with no dependents, attains the age of 65 on September 1, 1954. The aggregate adjusted gross income of D and his wife for 1954 is $4,840. D and his wife file a joint return for 1954 and are entitled to three exemptions, one for each taxpayer and one additional exemption for D because of his age. Since the adjusted gross income of D and his wife falls within the tax bracket $4,800–4,850, the tax on a joint return is $509.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7114, 36 FR 9018, May 18, 1971]

§ 1.4–2 Elections.

(a) *Making of election.* The election to pay the optional tax imposed under section 3 shall be made by (1) filing a return on Form 1040A, or (2) filing a return on Form 1040 and electing in such return, in accordance with the provisions of section 144 and the regulations thereunder, to take the standard deduction provided by section 141.

(b) *Election under section 3 and election of standard deduction.* Section 144 (a) and the regulations thereunder provide rules for treating an election to pay the tax under section 3 as an election to take the standard deduction, and for treating an election to take the standard deduction as an election to pay the tax under section 3. For example, if the taxpayer's return shows $5,000 or more of adjusted gross income and he elects to take the standard deduction, he will be deemed to have elected to pay the tax

under section 3 if it is subsequently determined that his correct adjusted gross income is less than $5,000.

(c) [Reserved]

(d) *Change of election.* For rules relating to a change of election to pay, or not to pay, the optional tax imposed under section 3, see section 144 (b) and the regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6581, 26 FR 11677, Dec. 6, 1961; T.D. 7269, 38 FR 9295, April 13, 1973]

§ 1.4-3 Husband and wife filing separate returns.

(a) *In general.* If the separate adjusted gross income of a husband is less than $5,000 and the separate adjusted gross income of his wife is less than $5,000, and if each is required to file a return, the husband and the wife must each elect to pay the optional tax imposed under section 3 or neither may so elect. If the separate adjusted gross income of each spouse is $5,000 or more, then neither spouse can elect to pay the optional tax imposed under section 3. If the adjusted gross income of one spouse is $5,000 or more and that of the other spouse is less than $5,000, the election to pay the optional tax imposed under section 3 may be exercised by the spouse having adjusted gross income of less than $5,000 only if the spouse having adjusted gross income of $5,000 or more, in computing taxable income, uses the standard deduction provided by section 141. If the spouse having adjusted gross income of $5,000 or more does not use the standard deduction, then the spouse having adjusted gross income of less than $5,000 may not elect to pay the optional tax and must compute taxable income without regard to the standard deduction. Accordingly, if the spouse having adjusted gross income of $5,000 or more itemizes the deductions allowed by sections 161 and 211 in computing taxable income, the spouse having adjusted gross income of less than $5,000 must also compute taxable income by itemizing the deductions allowed by sections 161 and 211, and must pay the tax imposed by section 1. For rules relative to the election to take the standard deduction by husband and wife, see part IV (section 141 and following), subchapter B, chapter 1 of the Code, and the regulations thereunder.

(b) *Taxable years beginning after December 31, 1963, and before January 1, 1970.* (1) In the case of a husband and wife filing a separate return for a taxable year beginning after December 31, 1963, and before January 1, 1970, the optional tax imposed by section 3 shall be—

(i) For taxable years beginning in 1964, the lesser of the tax shown in Table IV (relating to the 10-percent standard deduction for married persons filing separate returns) or Table V (relating to the minimum standard deduction for married persons filing separate returns) of section 3(a), and

(ii) For a taxable year beginning after December 31, 1964, and before January 1, 1970, the lesser of the tax shown in Table IV (relating to the 10-percent standard deduction for married persons filing separate returns) or Table V (relating to minimum standard deduction for married persons filing separate returns) of section 3(b).

(2) If the tax of one spouse is determined with regard to the 10-percent standard deduction provided for in Table IV of section 3(a) or 3(b) or if such spouse in computing taxable income uses the 10-percent standard deduction provided for in section 141(b), then the minimum standard deduction provided for in Table V of section 3(a) or 3(b) shall not apply in the case of the other spouse, if such spouse elects to pay the optional tax imposed under section (3). Thus, if a husband and wife compute their tax with reference to the standard deduction, one cannot elect to use the 10-percent standard deduction and the other elect to use the minimum standard deduction. However, an individual described in section 141(d)(2) may elect pursuant to such section and the regulations thereunder to pay the tax shown in Table V of section 3(a) or 3(b) in lieu of the tax shown in Table IV of section 3(a) or 3(b). See section 141(d) and the regulations thereunder for rules relating to the standard deduction in the case of married individuals filing separate returns.

(c) *Taxable years beginning after December 31, 1969.* (1) In the case of a husband and wife filing a separate

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return for a taxable year beginning after December 31, 1969, the optional tax imposed by section 3 shall be the lesser of the tax shown in—

(i) The table prescribed under section 3 applicable to such taxable year in the case of married persons filing separate returns which applies the percentage standard deduction, or

(ii) The table prescribed under section 3 applicable to such taxable year in the case of married persons filing separate returns which applies the low income allowance.

(2) If the tax of one spouse is determined by the table described in subparagraph (1)(i) of this paragraph or if such spouse in computing taxable income uses the percentage standard deduction provided for in section 141(b), then the table described in subparagraph (1)(ii) of this paragraph shall not apply in the case of the other spouse, if such other spouse elects to pay the optional tax imposed under section 3. Thus, if a husband and wife compute the tax with reference to the standard deduction, one cannot elect to use the percentage standard deduction and the other elect to use the low income allowance. A married individual described in section 141(d)(2) may elect pursuant to such section and the regulations thereunder to pay the tax shown in the table described by subparagraph (1)(ii) of this paragraph in lieu of the tax shown in the table described by subparagraph (1)(i) of this paragraph. See section 141(d) and the regulations thereunder for rules relating to the standard deduction in the case of married individuals filing separate returns.

(d) *Determination of marital status.* For the purpose of applying the restrictions upon the right of a married person to elect to pay the tax under section 3, (1) the determination of marital status is made as of the close of the taxpayer's taxable year or, if his spouse died during such year, as of the date of death; (2) a person legally separated from his spouse under a decree of divorce or separate maintenance on the last day of his taxable year (or the date of death of his spouse, whichever is applicable) is not considered as married; and (3) with respect to taxable years beginning after December 31, 1969, a person, although considered as married within the meaning of section 143(a), is considered as not married if he lives apart from his spouse and satisfies the requirements set forth in section 143(b). See section 143 and the regulations thereunder.

[T.D. 6792, 30 FR 529, Jan. 15, 1965, as amended by T.D. 7123, 36 FR 11084, June 9, 1971]

§ 1.4-4 Short taxable year caused by death.

An individual making a return for a period of less than 12 months on account of a change in his accounting period may not elect to pay the optional tax under section 3. However, the fact that the taxable year is less than 12 months does not prevent the determination of the tax for the taxable year under section 3 if the short taxable year results from the death of the taxpayer.

Tax on Corporations

§ 1.11-1 Tax on corporations.

(a) Every corporation, foreign or domestic, is liable to the tax imposed under section 11 except (1) corporations specifically excepted under such section from such tax; (2) corporations expressly exempt from all taxation under subtitle A of the Code (see section 501); and (3) corporations subject to tax under section 511(a). For taxable years beginning after December 31, 1966, foreign corporations engaged in trade or business in the United States shall be taxable under section 11 only on their taxable income which is effectively connected with the conduct of a trade or business in the United States (see section 882(a)(1)). For definition of the terms "corporations," "domestic," and "foreign," see section 7701(a) (3), (4), and (5), respectively. It is immaterial that a domestic corporation, and for taxable years beginning after December 31, 1966, a foreign corporation engaged in trade or business in the United States, which is subject to the tax imposed by section 11 may derive no income from sources within the United States. The tax imposed by section 11 is payable upon

the basis of the returns rendered by the corporations liable thereto, except that in some cases a tax is to be paid at the source of the income. See subchapter A (sections 6001 and following), chapter 61 of the Code, and section 1442.

(b) The tax imposed by section 11 consists of a normal tax and a surtax. The normal tax and the surtax are both computed upon the taxable income of the corporation for the taxable year, that is, upon the gross income of the corporation minus the deductions allowed by chapter 1 of the Code. However, the deduction provided in section 242 for partially tax-exempt interest is not allowed in computing the taxable income subject to the surtax.

(c) The normal tax is at the rate of 22 percent and is applied to the taxable income for the taxable year. However, in the case of a taxable year ending after December 31, 1974, and before January 1, 1976, the normal tax is at the rate of 20 percent of so much of the taxable income as does not exceed $25,000 and at the rate of 22 percent of so much of the taxable income as does exceed $25,000 and is applied to the taxable income for the taxable year.

(d) The surtax is at the rate of 26 percent and is upon the taxable income (computed without regard to the deduction, if any, provided in section 242 for partially tax-exempt interest) in excess of $25,000. However, in the case of a taxable year ending after December 31, 1974, and before January 1, 1976, the surtax is upon the taxable income (computed as provided in the preceding sentence) in excess of $50,000. In certain circumstances the exemption from surtax may be disallowed in whole or in part. See sections 269, 1551, 1561, and 1564 and the regulations thereunder. For purposes of sections 244, 247, 804, 907, 922 and §§ 1.51-1 and 1.815-4, when the phrase "the sum of the normal tax rate and the surtax rate for the taxable year" is used in any such section, the normal tax rate for all taxable years beginning after December 31, 1963, and ending before January 1, 1976, shall be considered to be 22 percent.

(e) The computation of the tax on corporations imposed under section 11 may be illustrated by the following example:

Example. The X Corporation, a domestic corporation, has gross income of $86,000 for the calendar year 1964. The gross income includes interest of $5,000 on United States obligations for which a deduction under section 242 is allowable in determining taxable income subject to the normal tax. It has other deductions of $11,000. The tax of the X Corporation under section 11 for the calendar year is $28,400 ($15,400 normal tax and $13,000 surtax) computed as follows:

COMPUTATION OF NORMAL TAX

Gross income		$86,000
Deductions:		
Partially tax-exempt interest	$5,000	
Other	11,000	16,000
Taxable income		70,000
Normal tax (22 percent of $70,000)		15,400

COMPUTATION OF SURTAX

Taxable income	70,000
Add: Amount of partially tax-exempt interest deducted in computing taxable income	5,000
Taxable income subject to surtax	75,000
Less: Exemption from surtax	25,000
Excess of taxable income subject to surtax over exemption	50,000
Surtax (26 percent of $50,000)	13,000

(f) For special rules applicable to foreign corporations engaged in trade or business within the United States, see section 882 and the regulations thereunder. For additional tax on personal holding companies, see part II (section 541 and following), subchapter G, chapter 1 of the Code, and the regulations thereunder. For additional tax on corporations improperly accumulating surplus, see part I (section 531 and following), subchapter G, chapter 1 of the Code, and the regulations thereunder. For treatment of China Trade Act corporations, see sections 941 and 942 and the regulations thereunder. For treatment of Western Hemisphere trade corporations, see sections 921 and 922 and the regulations thereunder. For treatment of capital gains and losses, see subchapter P (section 1201 and following), chapter 1 of the Code. For computation of the tax for a taxable year during which a change in the tax rates occurs, see section 21 and the regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7293, 38 FR 32792, Nov. 28, 1973; T.D. 74-13, 41 FR 12639, Mar. 26, 1976]

Changes in Rates During a Taxable Year

§ 1.21-1 Changes in rate during a taxable year.

(a) Section 21 applies to all taxpayers, including individuals and corporations. It provides a general rule applicable in any case where (1) any rate of tax imposed by chapter 1 of the Code upon the taxpayer is increased or decreased, or any such tax is repealed, and (2) the taxable year includes the effective date of the change, except where that date is the first day of the taxable year. For example, the normal tax on corporations under section 11(b) was decreased from 30 percent to 22 percent in the case of a taxable year beginning after December 31, 1963. Accordingly, the tax for a taxable year of a corporation beginning on January 1, 1964, would be computed under section 11(b) at the new rate without regard to section 21. However, for any taxable year beginning before January 1, 1964, and ending on or after that date, the tax would be computed under section 21. For additional circumstances under which section 21 is not applicable, see paragraph (k) of this section.

(b) In any case in which section 21 is applicable, a tentative tax shall be computed by applying to the taxable income for the entire taxable year the rate for the period within the taxable year before the effective date of change, and another tentative tax shall be computed by applying to the taxable income for the entire taxable year the rate for the period within the taxable year on or after such effective date. The tax imposed on the taxpayer is the sum of—

(1) An amount which bears the same ratio to the tentative tax computed at the rate applicable to the period within the taxable year before the effective date of the change that the number of days in such period bears to the number of days in the taxable year, and

(2) An amount which bears the same ratio to the tentative tax computed at the rate applicable to the period within the taxable year on and after the effective date of the change that the number of days in such period bears to the number of days in the taxable year.

(c) If the rate of tax is changed for taxable years "beginning after" or "ending after" a certain date, the following day is considered the effective date of the change for purposes of section 21. If the rate is changed for taxable years "beginning on or after" a certain date, that date is considered the effective date of the change for purposes of section 21. This rule may be illustrated by the following examples:

Example (1). Assume that the law provides that a change in a certain rate of tax shall be effective only with respect to taxable years beginning after December 31, 1969. The effective date of change for purposes of section 21 is January 1, 1970, and section 21 must be applied to any taxable year which begins before and ends on or after January 1, 1970.

Example (2). Assume that the law provides that a change in a certain rate of tax shall be applicable only with respect to taxable years ending after December 31, 1970. For purposes of section 21, the effective date of change is January 1, 1971, and section 21 must be applied to any taxable year which begins before and ends on or after January 1, 1971.

Example (3). Assume that the law provides that a change in a certain rate of tax shall be effective only with respect to taxable years beginning on or after January 1, 1971. The effective date of change for purposes of section 21 is January 1, 1971, and section 21 must be applied to any taxable year which begins before and ends on or after January 1, 1971.

(d) If a tax is repealed, the repeal will be treated as a change of rate for purposes of section 21, and the rate for the period after the repeal (for purposes of computing the tentative tax with respect to that period) will be considered zero. For example, the Tax Reform Act of 1969 repealed section 1562, which imposed a 6 percent additional tax on controlled corporations electing multiple surtax exemptions, effective for taxable years beginning after December 31, 1974. For such controlled corporations having taxable years beginning in 1974 and ending in 1975, the rate for the period ending

before January 1, 1975, would be 6 percent; the rate for the period beginning after December 31, 1974, would be zero. However, subject to the rules stated in this section, section 21 does not apply to the imposition of a new tax. For example, if a new tax is imposed for taxable years beginning on or after July 1, 1972, a computation under section 21 would not be required with respect to such new tax in the case of taxable years beginning before July 1, 1972, and ending on or after that date. If the effective date of the imposition of a new tax and the effective date of a change in rate of such tax fall in the same taxable year, section 21 is not applicable in computing the taxpayer's liability for such tax for such year unless the new tax is expressly imposed upon the taxpayer for a portion of his taxable year prior to the change in rate.

(e) If a husband and wife have different taxable years because of the death of either spouse, and if a joint return is filed with respect to the taxable year of each, then, for purposes of section 21, the joint return shall be treated as if the taxable years of both spouses ended on the date of the closing of the surviving spouse's taxable year. See section 6013 (c), relating to treatment of joint return after death of either spouse. Accordingly, if a change in the rate of tax is effective during the taxable year of the surviving spouse, the tentative taxes with respect to the joint return shall be computed on the basis of the number of days during which each rate of tax was in effect for the taxable year of the surviving spouse.

(f) Section 21 applies whether or not the taxpayer has a taxable year of less than 12 months. Moreover, section 21 applies whether or not the taxable income for a taxable year of less than 12 months is required to be placed on an annual basis under section 443. If the taxable income is required to be computed under section 443(b) then the tentative taxes under section 21 are computed as provided in paragraph (1) or (2) of section 443(b) and are reduced as provided in those paragraphs. The tentative taxes so computed and reduced are then apportioned as provided in section 21(a)(2) to determine the tax for such taxable year as computed under section 21.

(g) If a taxpayer has made the election under section 441(f) (relating to computation of taxable income on the basis of an annual accounting period varying from 52 to 53 weeks), the rules provided in section 441(f)(2) shall be applicable for purposes of determining whether section 21 applies to the taxable year of the taxpayer. Where a taxpayer has made the election under section 441(f) and where section 21 applies to the taxable year of the taxpayer the computation under section 21(a)(2) shall be made upon the basis of the actual number of days in the taxable year and in each period thereof.

(h)(1) Section 21 is applicable only if the rate of tax imposed by chapter 1 changes. Sections in which rates of tax are specified or incorporated by reference include the following: 1, 2, 3, 11, 511, 531, 541, 821, 831, 871, 881, 1201, and 1348 (for taxable years beginning after December 31, 1970). Except as provided in subparagraph (3) of this paragraph, section 21 is not applicable with respect to changes in the law relating to deductions from gross income, exclusions from or inclusions in gross income, or other items taken into account in determining the amount or character of income subject to tax. Moreover, section 21 is not applicable with respect to changes in the law relating to credits against the tax or with respect to changes in the law relating to limitations on the amount of tax. Section 21 is applicable, however, to all those computations specified in the section providing the rate of tax which are implicit in determining the rate. For example, if one of the tax brackets in the tax tables under section 3 were to be changed, section 21 would be applicable to that change. Thus, if the bracket relating to "at least $4,200 but not less than $4,250" for heads of households should be changed to increase or decrease the last sum specified, with corresponding changes being made in subsequent brackets, section 21 would be applicable. The enactment of sections 1561 and 1562 is considered a change in section 11(d) which constitutes a change in rate for the period ending after De-

cember 31, 1963. The amendment of section 1561 and the repeal of section 1562 by the Tax Reform Act of 1969 is considered a change in section 11(d) which constitutes a change in rate for the period ending after December 31, 1974. The repeal of the 2 percent additional tax imposed under section 1503 on corporations filing consolidated returns constitutes a change in rate for the period ending after December 31, 1963. The addition to the Code of section 1348 (relating to 50 percent maximum rate on earned income) is a change in rate to which section 21(a) is applicable. The amendment of section 11(d) by the Tax Reduction Act of 1975 which increases to $50,000 the surtax exemption for a taxable year ending during 1975 constitutes a change in rate for such portion of the taxable year (if less than the entire taxable year) as follows December 31, 1974. Similarly, the return of the surtax exemption to $25,000 for a taxable year ending during 1976 constitutes a change in rate for such portion of the taxable year (if less than the entire taxable year) as follows December 31, 1975.

(2) Ordinarily, both the old and the new rates are applied to the same amount of taxable income. However, where the rate of tax is itself taken into account in determining taxable income (for example, the special deduction for Western Hemisphere trade corporations under section 922), the taxable income used in determining the tentative tax employing the rate before the effective date of change shall be determined by reference to that rate of tax, and the taxable income for the purpose of determining the tentative tax employing the rate for the period on and after the effective date of the change shall be determined by reference to the new tax rate.

(3) Section 21 is applicable with respect to changes in the law relating to the standard deduction for individuals provided in part IV of subchapter B and to the deduction for personal exemptions for individuals provided in part V of subchapter B.

(i) If the rate of tax changes more than once during the taxable year, section 21 is applicable to each change in rate. For example, if the rate of normal tax changed for taxable years beginning on or after March 1, 1954, and changed again for taxable years beginning on or after June 1, 1954, section 21 requires computation of 3 tentative taxes for any taxable year which began before March 1, 1954, and ended on or after June 1, 1954: One tentative tax at the rate in effect before the March 1 change; another tentative tax at the rate in effect from March 1 to May 31; and a third tentative tax at the rate in effect from June 1 to the end of the taxable year. The proportion of each such tentative tax taken into account in determining the tax imposed on the taxpayer is computed by reference to the portion of the taxable year before March 1, 1954, by reference to the portion of the taxable year from March 1, 1954, through May 31, 1954, and by reference to the portion of the taxable year from June 1, 1954, to the end of the taxable year, respectively.

(j) (1) If a change in the rate of one tax imposed by chapter 1 of the Code does not affect the amount of other taxes imposed by chapter 1 of the Code the other taxes may be determined without regard to section 21 and section 21 will be applied only to the tax for which a change in rate is made. However, if the change of rate of one tax does affect the amount of other taxes imposed under chapter 1 of the Code, then the computation of the taxes under chapter 1 of the Code so affected shall be made by applying section 21. For example, if section 1201 applies to an individual taxpayer for a taxable year containing the effective date of a change in a rate of tax provided in section 1, then under section 21 the taxpayer must compute a tentative tax for each period for which a different rate of tax is effective under section 1. The tentative tax for each such period as computed under section 1201 will reflect the rate of tax provided by section 1 for such period.

(2) In certain cases chapter 1 of the Code provides that the particular tax to be imposed upon the taxpayer shall be one of several taxes, the basis of selection being the tax that is greater or lesser. See, for example, sections 821 and 1201. If in any such case the rate

of any one of these taxes changes, then the tentative taxes computed as provided by section 21 for each period shall be computed employing the tax selected in accordance with the general rule of selection for such a case, at the rate of tax in effect for such period. Thus, if a change in the rate of the alternative tax under section 1201 is such that the alternative tax under section 1201 is applicable if the old rate is used and is not applicable if the new rate is used, one tentative tax will consist of the alternative tax under section 1201 and the other tentative tax will consist of the tax imposed by the other applicable sections of chapter 1 of the Code. The two tentative taxes so computed are then prorated in accordance with section 21(a)(2) and the sum of the proportionate amounts is the tax imposed for the taxable year under chapter 1 of the Code. See the examples in paragraph (n) of this section.

(k) Section 21 does not apply in the following situations:

(1) The provisions of section 21 do not apply to the imposition of the tax surcharge by section 51. The proration rules of section 51(a) apply in the case of a taxable year ending on or after the effective date of the surcharge and beginning before July 1, 1970.

(2) The provisions of section 21 do not apply to the imposition of the minimum tax for tax preferences by section 56. The proration rules of section 301(c) of the Tax Reform Act of 1969 (83 Stat. 586) apply in the case of a taxable year beginning in 1969 and ending in 1970.

(l) In computing the number of days each rate of tax is in effect during the taxable year for purposes of section 21(a)(2), the effective date of the change in rate shall be counted in the period for which the new rate is in effect.

(m) Any credits against tax, and any limitation in any credit against tax, shall be based upon the tax computed under section 21. For credits against tax, see part IV (section 31 and following), subchapter A, chapter 1 of the Code.

(n) The application of section 21 may be illustrated by the following examples: (See also the examples in § 1.1561-2A(a)(3).)

Example (1). A, a married taxpayer filing a joint return, reports his income on the basis of a fiscal year ending June 30. For his fiscal year ending June 30, 1970, A reports taxable income (exclusive of capital gains and losses) of $50,000 and net long-term capital gain (section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)) of $75,000. The rate of tax on capital gains under section 1201(b) relating to the alternative tax has been increased from 25 percent to a maximum rate of 29½ percent with respect to gain in excess of $50,000 and the effective date of the change in rate is January 1, 1970. The income tax for the taxable year ended June 30, 1970, would be computed under section 21 as follows:

TENTATIVE TAX

Taxable income exclusive of capital gains and losses	$50,000
Long-term capital gain	75,000
	125,000
Deduct 50% of long-term capital gain	37,500
Taxable income	87,500
Tax under section 1 (1969 and 1970 rates)	37,690

ALTERNATIVE TAX UNDER SECTION 1201(b) (1969 RATES)

Taxable income ($50,000 + 50% of $75,000)	$87,500
Less 50% of long-term capital gain	37,500
Taxable income exclusive of capital gains	50,000
Partial tax (tax on $50,000)	17,060
Plus 25% of $75,000	18,750
Alternative tax under section 1201(b) at 1969 rates	35,810

ALTERNATIVE TAX UNDER SECTION 1201(b) (1970 RATES)

STEP I		
Taxable income ($50,000 + 50% of $75,000)	$87,500	
Deduct 50% of net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)	37,500	
	50,000	
Tax on $50,000 (taxable income exclusive of capital gains)		$17,060
STEP II		
(a) Net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)	75,000	
(b) Subsection (d) gain	50,000	
25% of $50,000 (lesser of (a) or (b))		12,500
STEP III		
(c) 29½% of $25,000 (excess of (a) over (b))	7,375	

(d) Ordinary income	$50,000		
50% of net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)	37,500		
	87,500		
Tax on $87,500		$37,690	
Ordinary income	$50,000		
50% of subsection (d) gain	25,000		
	75,000		
Tax on $75,000		30,470	
Difference		7,220	
Lesser of (c) or (d)			$7,220
Alternative tax (total of 3 Steps) at rates effective on and after January 1, 1970			36,780

Since the alternative tax is less than the tax imposed under section 1 for both the period in 1969 and the period in 1970, the alternative tax applies for both periods. Thus, since the effective date of the change in the rate of tax on capital gains is January 1, 1970, the old rate of alternative tax is effective for 184 days of the taxable year and the new rate of alternative tax is effective for 181 days of the taxable year. The alternative taxes are apportioned as follows:

1969—184/365 of $35,810	$18,052.16
1970—181/365 of $36,780	18,238.85
	36,291.01
Tax surcharge (See § 1.51-1(d)(1)(i))	2,729.28
Total tax for the taxable year	39,020.29

Example (2). B, a single individual not a head of a household, has a taxable year ending March 31. For the taxable year ending March 31, 1971, B has adjusted gross income of $18,500. His computation of the tax imposed is as follows:

1970 Tentative Tax

Adjusted gross income		$18,500.00
Less:		
Standard deduction	$1,000.00	
Personal exemption	625.00	1,625.00
Taxable income under 1970 deduction provisions		16,875.00
Tax on $16,875 (1970 rates):		
Tax on first $16,000	4,330.00	
42 percent of $875	367.50	
Tentative tax at rates and deduction provisions effective on or after January 1, 1970		4,697.50

1971 Tentative Tax

Adjusted gross income		$18,500.00
Less:		
Standard deduction	$1,500	
Personal exemption	$650	$2,150.00
Taxable income under 1971 deduction provisions		16,350.00
Tax on $16,350 (1971 rates):		
Tax on first $16,000	3,830	
34 percent of $350	119	
Tentative tax at rates and deduction provisions effective on or after Januray 1, 1971		3,949.00
The 1970 and 1971 tentative taxes are apportioned as follows:		
1970—275/365 of $4,697.50		3,539.21
1971—90/365 of $3,949.00		973.73
		4,512.94
Tax surcharge (see § 1.51-1(d)(1)(i))		56.26
Total tax for the taxable year		4,569.20

Example (3). H and W, husband and wife, have a foster child, C, who qualifies as a dependent under section 152(b)(2) for the period beginning after December 31, 1969. H and W file a joint return on the basis of a taxable year ending August 31. For the taxable year ending August 31, 1970, H and W have adjusted gross income of $12,500. Their computation of the tax imposed is as follows:

1969 Tentative Tax

Adjusted gross income		$12,500.00
Less:		
Standard deduction	$1,000.00	
Standard exemption (2)	1,200.00	2,200.00
Taxable income under 1969 deduction provisions		10,300.00
Taxable income reduced by one-half		5,150.00
Tax on $5,150 (1969 rates):		
Tax on first $4,000	$690.00	
22 percent of $1,150	253.00	943.00
Twice the tax on $5,150	$1,886.00	
Tentative tax at rates and deduction provisions effective on or after January 1, 1969		1,886.00

1970 Tentative Tax

Adjusted gross income		$12,500.00
Less:		
Standard deduction	$1,000.00	
Personal exemption (3)	1,875.00	2,875.00
Taxable income under 1970 deduction provisions		$9,625.00
Tax on $9,625 (1970 rates):		
Tax on first $8,000	$1,380.00	
22 percent of $1,625	357.50	
Tentative tax at rates and deduction provisions effective on or after January 1, 1970		1,737.50
The 1969 and 1970 tentative taxes are apportioned as follows:		
1969—122/365 of $1,886		$630.39
1970—243/365 of $1,737.50		1,156.75
		1,787.14
Tax surcharge (See § 1.51-1(d)(1)(i))		104.05
Total tax for the taxable year		1,891.19

Example (4). B, a single individual with one exemption, reports his income on the basis of a fiscal year ending June 30. For fiscal year ending June 30, 1971, B reports adjusted gross income of $250,000, consisting of earned net income of $240,000 and investment income of $10,000. In addition, on April 24, 1971, stock was transferred to B pursuant to his exercise of a qualified stock option, and the fair market value of such stock at that time exceeded the option price by $175,000. This $175,000 constitutes an item of tax preference described in section 57(a)(6). B claims itemized deductions in the amount of $34,000. By reason of section 1348, the maximum rate of tax on earned taxable income for a taxable year beginning after 1970 but before 1972 is 60 percent. The income tax for the taxable year ending June 30, 1971, would be computed under section 21 as follows:

1970 TENTATIVE TAX

Adjusted gross income		$250,000.00
Less:		
Itemized deductions	$34,000.00	
Personal exemption	625.00	34,625.00
Taxable income under 1970 deduction provisions		215,375.00
Tax on $215,375 (1970 rates)		
Tax on first $100,000	$55,490.00	
70 percent of $115,375	80,762.50	
Tentative tax at rates and deduction provisions effective on or after January 1, 1970		136,252.50
Minimum tax:		
Total tax preference items		175,000.00
Less:		
Exemption	$30,000.00	
Income tax	136,252.50	$166,252.50
Subject to 10 percent tax		8,747.50
10 percent tax		874.75
Total tentative tax ($136,252.50 + $874.75)		137,127.25

1971 TENTATIVE TAX

Adjusted gross income		$250,000.00
Less:		
Itemized deductions	$34,000.000	
Personal exemption	650.00	34,650.00
Taxable income under 1971 deduction provisions		215,350.00
(a) Tax on highest amount of taxable income on which rate does not exceed 60 percent ($50,000) (1971 rates)		20,190.00
(b) Earned taxable *income: ($215,350 × $240,000/$250,000)	$206,736.00	
Less: Tax preference offset: ($175,000 − $30,000)	145,000.00	
		61,736.00
(c) 60% of the amount by which $61,736 exceeds $50,000		7,041.60
(d) Tax on $215,350 (1971 rates)		
Tax on first $100,000	53,090.00	
70% of $115,350	80,745.00	
Total	133,835.00	
(e) Tax on $61,736 (1971 rates)		
Tax on first $60,000	26,390.00	
64% of $1,736	1,111.04	
Total	27,501.04	
(f) Excess of $133,835 over $27,501.04		106,333.96
Tentative tax (total of Steps (a), (c), and (f)) at rates and deduction provisions effective on or after January 1, 1971		133,565.56
Minimum tax:		
Total tax preference items		175,000.00
Less:		
Exemption	$30,000.00	
Income tax	133,565.56	163,565.56
Subject to 10 percent tax		$11,434.44
10 percent tax		1,143.44
Total tentative tax ($133,565.56 + $1,143.44)		134,709.00
The 1970 and 1971 tentative taxes are apportioned as follows:		
1970—184/365 of $137,127.25		69,127.16
1971—181/365 of $134,709		66,800.90
Total tax for the taxable year		135,928.06

Example (5). The surtax exemption of corporation M (one of 4 subsidiary corporations of W corporation), which files its income tax returns on the basis of a fiscal year ending March 31, 1964, is less than $25,000, by reason of section 1561 of the Code applicable to taxable years ending after December 31, 1963, and beginning before January 1, 1975. The taxable income of corporation M is $100,000, and the amount of the surtax exemption determined under the new rule for the 1964 taxable year is $5,000 ($25,000 ÷ 5). M's income tax liability for the taxable year ending March 31, 1964, is computed as follows:

1963 TENTATIVE TAX

Taxable income		$100,000
Normal tax on $100,000 (1963 rates) 30 percent of $100,000	$30,000	
Surtax on $75,000 (1963 rates and $25,000 surtax exemption) 22 percent of $75,000	16,500	
Total tentative tax at rates and surtax exemption effective before January 1, 1964		46,500

1964 TENTATIVE TAX

Taxable income		$100,000
Normal tax on $100,000 (1964 rates) 22 percent of $100,000	$22,000	

Surtax on $95,000 (1964 rates and a $5,000 surtax exemption) 28 percent of $95,000	26,600	
Total tentative tax at rates and surtax exemption effective after January 1, 1964		48,600
The 1963 and 1964 tentative taxes are apportioned as follows:		
1963—275/366 of $46,500		34,938.52
1964—91/366 of $48,600		12,083.61
Total tax for the taxable year		47,022.13

M has the same amount of taxable income in 1965. Its income tax liability for the fiscal year ending March 31, 1965, is computed as follows:

1964 TENTATIVE TAX

Taxable income		$100,000
Normal tax on $100,000 (1964 rates) 22 percent of $100,000	$22,000	
Surtax on $95,000 (1964 rates and a $5,000 surtax exemption) 28 percent of $95,000	26,600	
Total tentative tax at the 1964 rates		48,600

1965 TENTATIVE TAX

Taxable income		$100,000
Normal tax on $100,000 (1965 rates) 22 percent of $100,000	$22,000	
Surtax on $95,000 (1965 rates and a $5,000 surtax exemption) 26 percent of $95,000	24,700	
Total tentative tax at the 1965 rates		46,700
The 1964 and 1965 tentative taxes are apportioned as follows:		
1964—275/365 of $48,600		$36,616.44
1965—90/365 of $46,700		11,515.07
Total tax for the taxable year		48,131.51

Example (6). Assume the same facts as in example (5), except that M elected the additional tax under section 1562 for its fiscal year ending March 31, 1964. M's tax liability is completed as follows:

1963 TENTATIVE TAX

Taxable income		$100,000
Normal tax on $100,000 (1963 rates) 30 percent of $100,000	$30,000	
Surtax on $75,000 (1963 rates and $25,000 surtax exemption) 22 percent of $75,000	16,500	
Total tentative tax at rates and surtax exemption effective before January 1, 1964		46,500

1964 TENTATIVE TAX

Taxable income		$100,000
Normal tax on $100,000 (1964 rates) 22 percent of $100,000	$22,000	
Surtax on $75,000 (1964 rates and $25,000 surtax exemption) 28 percent of $75,000	21,000	
Additional tax on $25,000 6 percent of $25,000	1,500	
Total tentative tax at rates and surtax exemption effective on and after January 1, 1964		44,500
The 1963 and 1964 tentative taxes are apportioned as follows:		
1963—275/366 of $46,500		$34,938.52
1964—91/366 of $44,500		11,064.21
Total tax for the taxable year		46,002.73

Example (7). Corporation N files its income tax returns on the basis of a fiscal year ending June 30. For its taxable year ending in 1976, the taxable income of N is $100,000. N's income tax liability is determined for the period July 1, 1975, through December 31, 1975, by taking into account two rates of normal tax under section 11(b)(2) (A) and (B) and the increase to $50,000 in the surtax exemption under section 11(d). For the period January 1, 1976, through June 30, 1976, N's income tax liability is determined by taking into account the single normal tax rate under section 11(b)(1) and the $25,000 surtax exemption under section 11(d). N's tax liability for the taxable year ending June 30, 1976, is computed as follows:

1975 TENTATIVE TAX

Taxable income		$100,000
Normal tax on $100,000 (1975 rates) 20 percent of $25,000	$5,000	
22 percent of $75,000	16,500	
Surtax on $50,000 (1975 rates and $50,000 surtax exemption) 26 percent of $50,000	13,000	
Total tentative tax at rates and surtax exemption effective on and after January 1, 1975		34,500

1976 TENTATIVE TAX

Taxable income		$100,000
Normal tax on $100,000 (1976 rates) 22 percent of $100,000	$22,000	
Surtax on $75,000 (1976 rates and $25,000 surtax exemption) 26 percent of $75,000	19,500	
Total tentative tax at rates and surtax exemption effective on and after January 1, 1976		41,500
The 1975 and 1976 tentative taxes are apportioned as follows:		
1975—184/366 of $34,500		$17,344

1976—182/366 of $41,500	20,637
Total tax for the taxable year	37,981

(Secs. 1561(a) (83 Stat. 599; 26 U.S.C. 1561(a)) of the Internal Revenue Code)

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7164, 37 FR 4190, Feb. 29, 1972; T.D. 74-13, 41 FR 12639, Mar. 26, 1976; T.D. 7528, 42 FR 64694, Dec. 28, 1977; T.D. 7728, 45 FR 72651, Nov. 3, 1980]

Credits Against Tax

CREDITS ALLOWABLE

§ 1.31-1 Credit for tax withheld on wages.

(a) The tax deducted and withheld at the source upon wages under chapter 24 of the Internal Revenue Code of 1954 (or in the case of amounts withheld in 1954, under subchapter D, chapter 9 of the Internal Revenue Code of 1939) is allowable as a credit against the tax imposed by subtitle A of the Internal Revenue Code of 1954, upon the recipient of the income. If the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer. For the purpose of the credit, the recipient of the income is the person subject to tax imposed under subtitle A upon the wages from which the tax was withheld. For instance, if a husband and wife domiciled in a State recognized as a community property State for Federal tax purposes make separate returns, each reporting for income tax purposes one-half of the wages received by the husband, each spouse is entitled to one-half of the credit allowable for the tax withheld at source with respect to such wages.

(b) The tax withheld during any calendar year shall be allowed as a credit against the tax imposed by subtitle A for the taxable year of the recipient of the income which begins in that calendar year. If such recipient has more than one taxable year beginning in that calendar year, the credit shall be allowed against the tax for the last taxable year so beginning.

§ 1.31-2 Credit for "special refunds" of employee social security tax.

(a) *In general.* (1) In the case of an employee receiving wages from more than one employer during the calendar year, amounts may be deducted and withheld as employee social security tax with respect to more than $3,600 of wages received during the calendar year 1954, and with respect to more than $4,200 of wages received during a calendar year after 1954. For example, employee social security tax may be deducted and withheld on $5,000 of wages received by an employee during a particular calendar year if the employee is paid wages in such year in the amount of $3,000 by one employer and in the amount of $2,000 by another employer. Section 6413(c) (as amended by section 202 of the Social Security Amendments of 1954 (68 Stat. 1089)), permits, under certain conditions, a so-called "special refund" of the amount of employee social security tax deducted and withheld with respect to wages paid to an employee in a calendar year after 1954 in excess of $4,200 ($3,600 for the calendar year 1954) by reason of the employee receiving wages from more than one employer during the calendar year. For provisions relating to the imposition of the employee tax and the limitation on wages, see with respect to the calendar year 1954, sections 1400 and 1426(a)(1) of the Internal Revenue Code of 1939 and, with respect to calendar years after 1954, sections 3101 and 3121(a)(1) of the Internal Revenue Code of 1954, as amended by sections 208(b) and 204(a), respectively, of the Social Security Amendments of 1954 (68 Stat. 1094, 1091).

(2) An employee who is entitled to a special refund of employee tax with respect to wages received during a calendar year and who is also required to file an income tax return for such calendar year (or for his last taxable year beginning in such calendar year) may obtain the benefits of such special refund only by claiming credit for such special refund in the same manner as if such special refund were an amount deducted and withheld as income tax at the source. For provisions for claiming special refunds for

1955 and subsequent years in the case of employees not required to file income tax returns, see section 6413(c) and the regulations thereunder. For provisions relating to such refunds for 1954, see 26 CFR (1939) § 408.802 (regulations 128).

(3) The amount of the special refund allowed as a credit shall be considered as an amount deducted and withheld as income tax at the source under chapter 24 of the Internal Revenue Code of 1954 (or, in the case of a special refund for 1954, Subchapter D, chapter 9 of the Internal Revenue Code of 1939). If the amount of such special refund when added to amounts deducted and withheld as income tax exceeds the taxes imposed by subtitle A of the Internal Revenue Code of 1954, the amount of the excess constitutes an overpayment of income tax under subtitle A, and interest on such overpayment is allowed to the extent provided under section 6611 upon an overpayment of income tax resulting from a credit for income tax withheld at source. See section 6401(b).

(b) *Federal and State employees and employees of certain foreign corporations.* The provisions of this section shall apply to the amount of a special refund allowable to an employee of a Federal agency or a wholly owned instrumentality of the United States, to the amount of a special refund allowable to an employee of any State or political subdivision thereof (or any instrumentality of any one or more of the foregoing), and to the amount of a special refund allowable to employees of certain foreign corporations. See, with respect to such special refunds for 1954, section 1401(d)(4) of the Internal Revenue Code of 1939, and with respect to such special refunds for 1955 and subsequent years, section 6413(c)(2) of the Internal Revenue Code of 1954, as amended by section 202 of the Social Security amendments of 1954.

§ 1.34–1 Credit against tax and exclusion from gross income in case of dividends received by individuals.

(a) *In general.* (1) Section 34 provides a credit against the income tax of an individual for certain dividends received after July 31, 1954, and on or before December 31, 1964. The credit, subject to the limitations provided in section 34(b), is equal to 4 percent of the dividends received before January 1, 1964, and 2 percent of the dividends received during the calendar year 1964. The credit is allowable with respect to dividends received in any taxable year ending after July 31, 1954, but applies only to dividends received on or before December 31, 1964. The credit applies only to dividends which are received from domestic corporations and which are included in the gross income of the taxpayer. Section 116 provides for the exclusion from gross income of the first $100 ($50 for dividends received in taxable years beginning before January 1, 1964) of certain dividends received by an individual. See § 1.116–1. In determining which dividends are entitled to the credit against income tax provided by section 34, the exclusion from gross income provided in section 116 is applied to the first dividends received in the taxable year. Since the exclusion applies to dividends received at any time during a taxable year ending after July 31, 1954, dividends received before August 1, 1954, may be taken into account in determining the exclusion from gross income under section 116 but do not constitute dividends for which a credit is allowed.

(2) The application of section 34 (without regard to the limitations provided in section 34(b)) may be illustrated by the following example:

Example. A, an individual who makes his return on the basis of the calendar year, receives in the year 1954 the following dividends: $100 on March 1, $100 on June 1, $100 on September 1, and $100 on December 1. $50 of the dividends received by A on March 1, 1954, is excluded from gross income under section 116. The balance of the dividends received in 1954, amounting to $350, is includible in the gross income of A. Subject to the limitation in section 34(b) a credit of $8 is allowed under section 34 (4 percent of $200, the amount of the dividends received after July 31, 1954, that is, $100 received on September 1, 1954, and $100 received on December 1, 1954).

(b) *Tax credit.* The credit is used to reduce the tax imposed by subtitle A of the Code, including the alternative tax under section 1201 in the case of

capital gains and the self-employment tax under chapter 2 of the Code; however, it may not be used by the taxpayer as a credit against penalties, additions to the tax, or interest on delinquent taxes.

(c) *Joint return of husband and wife.* (1) In the case of a joint return the credit is determined on the basis of the dividends received by both the husband and wife after taking into account the exclusion allowed by section 116. See § 1.116-1. The credit is allowable in the case of a joint return on account of the dividends received by each spouse without regard to whether the spouse would be liable for the tax imposed by subtitle A if the joint return had not been filed. However, the limitations on amount of credit in section 34(b) are determined by reference to the tax and the credit under section 33 required to be shown on the joint return and to the combined taxable income of husband and wife. For this purpose, it makes no difference whether the tax, the credit, or the taxable income is attributable to one or the other spouse. If both the husband and wife are entitled to the credit, their combined credit shall not exceed the amount so computed.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). H and W, husband and wife, make a joint return for the calendar year 1954. The only dividend received by either of them during the year is a dividend received by H on September 1 in the amount of $400. Subject to the limitations of section 34(b), the credit amounts to $14 (4 percent of $350, the dividends included in gross income after allowance of the exclusion of $50 under section 116).

Example (2). The facts are the same as in example (1) except that W also received a dividend on September 1 of $30. Since this dividend (being less than the maximum amount allowable as an exclusion under section 116(a)) is excluded from W's gross income, it does not affect the computation of the tax credit and the tax credit is the same as in example (1).

Example (3). H and W, husband and wife, make a joint return for the calendar year 1954. H and W each received a $400 dividend on September 1, 1954, and these were the only dividends received by them in 1954. Since H and W may each exclude $50 of the dividends received by them, $700 of dividend income is included in gross income. Subject to the limitations in section 34(b), the credit against the tax of H and W amounts to $28 (4 percent of $700).

(d) *Individuals receiving dividends.* Where two or more persons hold stock as tenants in common, as joint tenants, or as tenants by the entirety, the dividends received with respect to such stock shall be considered as being received by each tenant to the extent that he is entitled under local law to a share of such dividends. Where dividends constitute community property under local law each spouse shall be considered as receiving one-half of such dividends.

(e) *Time dividends are received.* In cases where it is necessary to determine the time of receipt of dividends, the rules established to determine in which taxable year dividends must be included in gross income apply, including the rules relating to constructive receipt. See section 451 and regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6777, 29 FR 17806, Dec. 16, 1964]

§ 1.34-2 Limitations on amount of credit.

(a) Under section 34(b) the credit may not exceed the lesser of either—

(1) The amount of the tax imposed by chapter 1 of the Code for the taxable year reduced by the foreign tax credit allowable under section 33, or

(2) Whichever of the following is applicable:

(i) In the case of a taxable year ending before January 1, 1955, or beginning after December 31, 1963, 2 percent of the taxable income for such taxable year;

(ii) In the case of a taxable year ending after December 31, 1954, and beginning before January 1, 1964, 4 percent of the taxable income for such taxable year. In the case of a taxpayer who computes his tax under section 3 or who uses the standard deduction provided by section 141, the taxable income for the taxable year is the adjusted gross income for the taxable year reduced by the standard deduction prescribed in section 141 and the deductions for personal exemptions provided in section 151. Where the alternative tax on capital gains is im-

posed under section 1201(b), the taxable income for such taxable year is the taxable income as defined in section 63, which includes 50 percent of the excess of net long-term capital gain over net short-term capital loss.

(b) The application of the limitations in paragraph (a) of this section may be illustrated by the following example:

Example. Assume the following facts in the case of an individual whose taxable year is the calendar year:

1954

Computation of tax liability without regard to the dividend received credit:

(1) Gross income	$7,500
(2) Deductions	2,900
(3) Taxable income	4,600
(4) Income tax liability	996
(5) Foreign tax credit	16
(6) Income tax liability minus foreign tax credit	980

Computation of limitation under section 34(b)(1):

(7) Dividends for which credit is allowable	$2,500
(8) Dividends received credit under section 34(a); (2,500 × 0.04)	100
(9) Dividends received credit, as limited by section 34(b)(1); (item (6) or item (8) whichever is lesser)	100

Computation of limitation under section 34(b)(2):

(10) Taxable income	$4,600
(11) Dividends received credit under section 34(b)(2); (4,600 × 0.02)	92

Dividends received credit allowable:

Item (6), item (9), or item (11), whichever is lesser	$92

1955

Computation of tax liability without regard to the dividend received credit:

(12) Gross income	$7,500
(13) Deductions	2,900
(14) Taxable income	4,600
(15) Income tax liability	996
(16) Foreign tax credit	816
(17) Income tax liability minus foreign tax credit	180

Computation of limitation under section 34(b)(1):

(18) Dividends for which credit is allowable	$2,500
(19) Dividends received credit under section 34(a); (2,500 × 0.04)	100
(20) Dividends received credit as limited by section 34(b)(1); (item (17) or item (19) whichever is lesser)	100

Computation of limitation under section 34(b)(2):

(21) Taxable income	$4,600
(22) Dividends received credit under section 34(b)(2); (4,600 × 0.04)	184

Dividends received credit allowable:

Item (17), item (19), or item (22), whichever is lesser	$100

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6777, 29 FR 17807, Dec. 16, 1964]

§ 1.34-3 Dividends to which the credit and exclusion apply.

(a) *General rule.* The credit under section 34 and the exclusion under section 116 apply only to distributions of property defined as dividends by section 316. Thus, the credit and the exclusion are not allowed with respect to patronage dividends paid by either exempt or taxable farm cooperatives. Nor are they allowed for distributions to nonstockholding policyholders by an insurance company having shares of stock or for any distribution by a mutual insurance company. See paragraph (b) of this section for an additional restriction with respect to stock life insurance companies. The credit and the exclusion are, however, allowed with respect to dividends paid on capital stock by nonexempt cooperatives and with respect to dividends paid on capital stock by building and loan associations. However, see paragraph (b) of this section with respect to so-called dividends paid by building and loan associations ineligible for the credit and the exclusion. The credit and the exclusion are allowed with respect to distributions from any organization taxed as a corporation if the distribution falls within the definition of a dividend in section 316.

(b) *Dividends from certain corporations.* (1) Section 34 (c) and (d) contains further restrictions on the type of distributions which are treated as dividends for purposes of the credit and exclusion. Thus, no credit or exclusion is applicable with respect to dividends received from a corporation

organized under the China Trade Act, 1922; from stock life insurance companies before January 1, 1959, in taxable years ending before such date; from corporations which during their taxable year of the distribution or their preceding taxable year were corporations to which section 931 applies (relating to income from sources within possessions of the United States); from corporations which during the taxable year of the distribution or the preceding taxable year are corporations exempt from tax either under section 501, relating to charitable, etc., organizations, or under section 521, relating to farmers' cooperative associations.

(2) So-called dividends paid by mutual savings banks, cooperative banks, and building and loan associations which are allowed as a deduction under section 591 are ineligible for the credit and exclusion.

(3) For special rules as to the limitation on the amount of dividends for which a credit and exclusion are allowable in the case of dividends paid by a regulated investment company, see section 854 and the regulations thereunder.

(4) See section 857(c) and paragraph (d) of § 1.857–4 for special rules which deny a credit under section 34 and exclusion under section 116 in the case of dividends received from a real estate investment trust with respect to a taxable year for which such trust is taxable under part II, subchapter M, chapter 1 of the Code.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4092, Apr. 28, 1962; T.D. 6625, 27 FR 12541, Dec. 19, 1962]

§ 1.34–4 Taxpayers not entitled to credit and exclusion.

(a) The credit or exclusion is not available to nonresident aliens with respect to whom a tax is imposed for the taxable year under section 871(a). If the taxpayer elects under section 6014 to have the Government compute his tax, the credit is not taken into account in such computation although the taxpayer is allowed the exclusion under section 116.

(b) For treatment of dividends received by estates or trusts, and the allocation of such dividends between an estate or trust and the beneficiary thereof, see sections 642, 652, and 662 and the regulations thereunder.

(c) For treatment of dividends received by a partnership see section 702 and the regulations thereunder.

(d) For treatment of dividends received by a common trust fund, see section 584 and the regulations thereunder.

§ 1.34–5 Effective date; taxable years ending after July 31, 1954, subject to the Internal Revenue Code of 1939.

Pursuant to section 7851(a)(1)(C), the regulations prescribed in §§ 1.34–1 to 1.34–4, inclusive, shall also apply to taxable years beginning before January 1, 1954, and ending after July 31, 1954, and to taxable years beginning after December 31, 1953, and ending after July 31, 1954, but before August 17, 1954, though such years are subject to the Internal Revenue Code of 1939.

§ 1.34–6 Dividends received after December 31, 1964.

In the case of dividends received after December 31, 1964, section 34 and the regulations issued thereunder do not apply.

[T.D. 6777, 29 FR 17807, Dec. 16, 1964]

§ 1.35–1 Partially tax-exempt interest received by individuals.

(a) The credit against tax under section 35 shall be allowed only to individuals and if the requirements of both paragraphs (1) and (2) of section 35(a) are met. Where the alternative tax on capital gains is imposed under section 1201(b), the taxable income for such taxable year is the taxable income as defined in section 63, which includes 50 percent of the excess of net long-term capital gain over net short-term capital loss.

(b) For the treatment of partially tax-exempt interest in the case of amounts not allocable to any beneficiary of an estate or trust, see section 642(a)(1), and for treatment of amounts allocable to a beneficiary, see sections 652 and 662. For treatment of partially tax-exempt interest received by a partnership, see section 702(a)(7). For treatment of such interest re-

ceived by a common trust fund, see section 584(c)(2).

(c) The application of section 35 may be illustrated by the following example:

Example. In his taxable year, 1955, A received $4,500 of partially tax-exempt interest. A's taxable income is $4,000 upon which the tax prior to any credits against tax is $840. His foreign tax credit under section 33 is $610, and his dividends received credit under section 34 is $120. A's credit under section 35 for partially tax-exempt interest is $110, determined as follows:

Section 35(a)		
Partially tax-exempt interest		$4,500
Credit computed under section 35(a); 3 percent of $4,500		135
Section 35(b)(1)		
Tax imposed by chapter 1		840
Less:		
Credit allowed under section 33	$610	
Credit allowed under section 34	120	
		$730
Limitation on credit under section 35(b)(1)		110
Section 35(b)(2)		
Taxable income		4,000
Limitation on credit under section 35(b)(2); 3 percent of $4,000		120

Since of the three figures ($135, $110, and $120), the lesser is $110, A's credit under section 35 is limited to $110.

§ 1.35–2 Taxpayers not entitled to credit.

For taxable years beginning after December 31, 1957, no credit shall be allowed under section 35 to a nonresident alien individual with respect to whom a tax is imposed for such taxable year under section 871(a).

§ 1.37–1 General rules for the credit for the elderly.

(a) *In general.* In the case of an individual, section 37 provides a credit against the tax imposed by chapter 1 of the Internal Revenue Code of 1954. This section and §§ 1.37–2 and 1.37–3 provide guidance in the computation of the credit for the elderly provided under section 37 for taxable years beginning after 1975. For rules relating to the computation of the retirement income credit provided under section 37 for taxable years beginning before 1976, see 26 CFR 1.37–1 through 1.37–5 (Rev. as of April 1, 1980). Note that section 403 of the Tax Reduction and Simplification Act of 1977 provides that a taxpayer may elect to compute the credit under section 37 for the taxpayer's first taxable year beginning in 1976 in accordance with the rules applicable to taxable years beginning before 1976.

(b) *Limitation on the amount of the credit.* The credit allowed by section 37 for a taxable year shall not exceed the tax imposed by chapter 1 of the Code for the taxable year (reduced, in the case of a taxable year beginning before 1979, by the general tax credit allowed by section 42).

(c) *Married couples must file joint returns.* If the taxpayer is married at the close of the taxable year, the credit provided by section 37 shall be allowed only if the taxpayer and the taxpayer's spouse file a joint return for the taxable year. The preceding sentence shall not apply in the case of a husband and wife who are not members of the same household at any time during the taxable year. For the determination of marital status, see §§ 143 and 1.143–1.

(d) *Nonresident aliens ineligible.* No credit is allowed under section 37 to any individual for any taxable year during which that individual is at any time a nonresident alien unless the individual is treated, by reason of an election under section 6013 (g) or (h), as a resident of the United States for that taxable year.

[T.D. 7743, 45 FR 84049, Dec. 22, 1980]

§ 1.37–2 Credit for individuals age 65 or over.

(a) *In general.* This section illustrates the computation of the credit for the elderly in the case of an individual who has attained the age of 65 before the close of the taxable year. This section shall not apply to an individual for any taxable year for which the individual makes the election described in section 37(e)(2) and paragraph (b) of § 1.37–3.

(b) *Computation of credit.* The credit for the elderly for an individual to whom this section applies equals 15 percent of the individual's "section 37 amount" for the taxable year. An individual's "section 37 amount" for a taxable year is the initial amount determined under section 37(b)(2), reduced

as provided in section 37(b)(3) and (c)(1).

(c) *Examples.* The computation of the credit for the elderly for individuals to whom this section applies may be illustrated by the following examples:

Example (1). A, a single individual who is 67 years old, has adjusted gross income of $8,000 for the calendar year 1977. A also receives social security payments of $1,450 during 1977. A does not itemize deductions. A's credit for the elderly is $120, computed as follows:

Initial amount under section 37(b)(2)		$2,500
Reductions required by section 37 (b)(3) and (c)(1):		
Social security payments	$1,450	
One-half the excess of adjusted gross income over $7,500	250	1,700
Section 37 amount		800
15 pct of $800		$120

A's tax from the tax tables, which reflect the allowance of the general tax credit, is $662. Accordingly, the limitation of section 37(c)(2) and paragraph (b) of § 1.37-1 does not reduce A's credit for the elderly.

Example (2). H and W, who have both attained the age of 65, file a joint return for calendar year 1977. For that year H and W have adjusted gross income of $8,120; H also receives a railroad retirement pension of $1,550, and W receives social security payments of $1,200. H and W do not itemize deductions. The credit for the elderly allowed to H and W for 1977 is $139, computed as follows:

Initial amount under section 37(b)(2)		$3,750
Reductions required by section 37 (b)(3):		
Railroad retirement pension	$1,550	
Social Security payments	1,200	2,750
Section 37 amount		1,000
15 pct of $1,000		150
Limitation based upon amount of tax (derived from table reflecting allowance of general tax credit)		$139

Since the adjusted gross income of H and W is not greater than $10,000, no reduction of the initial amount is required under section 37 (c)(1).

[T.D. 7743, 45 FR 84050, Dec. 22, 1980]

§ 1.37-3 Credit for individuals under age 65 who have public retirement system income.

(a) *In general.* This section provides rules for the computation of the credit for the elderly under section 37(e) in the case of an individual who has not attained the age of 65 before the close of the taxable year and whose gross income for the taxable year includes retirement income within the meaning of paragraph (d)(1)(ii) of this section (*i.e.*, under a public retirement system). If such an individual is married within the meaning of section 143 at the close of the taxable year and the spouse of the individual has attained the age of 65 before the close of the taxable year, this section shall apply to the individual for the taxable year only if both spouses make the election described in paragraph (b) of this section. If both spouses make the election described in paragraph (b) of this section for the taxable year, the credit of each spouse shall be determined under the rules of this section. See paragraph (f)(2) of this section for a limitation on the effects of community property laws in making determinations and computations under section 37(e) and this section.

(b) *Election by certain married taxpayers.* If a married individual under age 65 at the close of the taxable year has retirement income and the spouse of that individual has attained the age of 65 before the close of the taxable year, both spouses may elect to compute the credit provided by section 37 under the rules of section 37(e) and this section. The spouses shall signify the election on the return (or amended return) for the taxable year in the manner prescribed in the instructions accompanying the return. The election may be made at any time before the expiration of the period of limitation for filing claim for credit or return for the taxable year. The election may be revoked without the consent of the Commissioner at any time before the expiration of that period by filing an amended return.

(c) *Computation of credit.* The credit of an individual under section 37(e) and this section equals 15 percent of the individual's credit base for the taxable year. The credit base of an individual for a taxable year is the lesser of—

(1) The retirement income of the individual for the taxable year, or

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(2) The amount determined under section 37(e)(5), as modified by section 37(e) (6) and (7).

(d) *Retirement income*—(1) *General rule*—(i) *For individuals 65 or over.* Section 37(e)(4)(A) enumerates the kinds of income which may be treated as the retirement income of an individual who has attained the age of 65 before the close of the taxable year. They include income from pensions and annuities, interest, rents, dividends, certain bonds received under a qualified bond purchase plan, and certain individual retirement accounts or annuities.

(ii) *For individuals under 65.* In the case of an individual who has not attained the age of 65 before the close of the taxable year, retirement income consists only of income from pensions and annuities (including disability annuity payments) under a public retirement system which arises from services performed by that individual or by a present or former spouse of that individual. The term "public retirement system" means a pension, annuity, or retirement, or similar fund or system established by the United States, a State, a possession of the United States, any political subdivision of any of the foregoing, or the District of Columbia.

(2) *Rents.* For purposes of section 37(e)(4)(A)(iii), income from rents shall be the gross amount received, not reduced by depreciation or other expenses, except that beneficiaries of a trust or estate shall treat as retirement income only their proportionate shares, of the taxable rents of the trust or estate. In the case of an amount received for board and lodging, only the portion of the amount received for lodging is income from rents.

(3) *Disability annuity payments received by individual under age 65.* Disability annuity payments received under a public retirement system by an individual under age 65 at the close of the taxable year shall not be treated as retirement income unless the payments are for periods after the date on which the individual reached minimum retirement age, that is, the age at which the individual would be eligible to receive a pension or annuity without regard to disability, and any of the following conditions is satisfied—

(i) The individual is precluded from seeking the benefits of section 105(d) (relating to certain disability payments) for that taxable year by reason of an irrevocable election;

(ii) The individual was not permanently and totally disabled at the time of retirement (and was not permanently and totally disabled either on January 1, 1976, or on January 1, 1977, if the individual retired before the later date on disability or under circumstances which entitled the individual to retire on disability); or

(iii) The payments are for periods after the individual reached mandatory retirement age.

For purposes of this paragraph, disability annuity payments include payments to an individual who retired on partial or temporary disability.

(4) *Compensation of personal services rendered during taxable year.* Retirement income does not include any amount representing compensation for personal services rendered during the taxable year. For this purpose, amounts received as a pension shall not be treated as representing compensation for personal services rendered during the taxable year if the period of service during the taxable year is not substantial when compared with the total years of service. For example, an individual on the calendar year basis retires on November 30 after 5 years of service and receives a pension during the remainder of his taxable year. The pension is not treated as representing compensation for personal services rendered during such taxable year merely because it is paid by reason of the services of the individual for a period of 5 years which includes a portion of the taxable year.

(5) *Amounts not includible in gross income.* Retirement income does not include any amount not includible in the gross income of the individual for the taxable year. For example, if a portion of an annuity is excluded from gross income under section 72, relating to annuities, that portion of the annuity is not retirement income; similarly, the portion of dividend income ex-

cluded from gross income under section 116, relating to the partial exclusion of dividends received by individuals is not retirement income.

(e) *Earned income*—(1) *In general.* The term "earned income" in section 37(e)(5)(B) generally has the same meaning as in section 911(b), except that earned income does not include any amount received as a pension or annuity. See section 911(b) and the regulations thereunder. Section 911(b) provides, in general, that earned income includes wages, salaries, professional fees, and other amounts received as compensation for personal services rendered.

(2) *Earned income from self-employment.* For purposes of section 37(e)(5)(B), the earned income of a taxpayer from self-employment in a trade or business shall not exceed—

(i) The taxpayer's share of the net profits from the trade or business if capital is not a material income-producing factor in that trade or business; or

(ii) Thirty percent of the taxpayer's share of the net profits from the trade or business if capital is a material income-producing factor in that trade or business.

For other rules relating to the determination of earned income from self-employment in a trade or business, see section 911(b) and the regulations thereunder.

(3) *Disability annuity payments received by individuals under age 65.* Disability annuity payments received under a public retirement system by an individual under age 65 at the close of the taxable year shall be treated as earned income for purposes of section 37(e)(5)(B) unless the payments are treated as retirement income under paragraph (d)(3) of this section.

(f) *Computation of credit under section 37(e) in the case of joint returns*—(1) *In general.* In the case of a joint return of husband and wife, the credit base of each spouse under section 37(e) is computed separately. The spouses then combine their credit bases and compute a single credit. The limitation in section 37(c)(2) and paragraph (b) of § 1.37-1 on the amount of the credit is determined by reference to the joint tax liability of the spouses. Thus, regardless of whether a spouse would be liable for the tax imposed by chapter 1 of the Code if the joint return had not been filed, the credit base of that spouse is taken into account in computing the credit.

(2) *Community property laws.* For taxable years beginning after 1977, married individuals filing joint returns shall disregard community property laws in making any determination or computation required under section 37(e) or this section. Each item of income is attributed in full to the spouse whose income it would have been in the absence of community property laws. Thus, if a 67-year old individual files a joint return with a 62-year old spouse for 1979 and the only income of the couple is from a public pension of the older spouse, that public pension is attributed in full to the older spouse for purposes of section 37(e) even though the applicable community property law may treat one-half of the pension as the income of the 62-year old spouse. Since the younger spouse consequently has no retirement income within the meaning of paragraph (d) of this section, the couple may not make the election described in paragraph (b) of this section.

(g) *Examples.* The computation of the credit for the elderly under section 37(e) and this section is illustrated by the following examples:

Example (1). B, who is 62 years old and single, receives a fully taxable pension of $2,400 from a public retirement system during 1977. B performed the services giving rise to the pension. During that year, B also earns $2,650 from a part-time job. B receives no tax-exempt pension or annuity in 1977. Subject to the limitation of section 37(c)(2) and paragraph (b) of § 1.37-1, B's credit for the elderly for 1977 under section 37(e) is $195, computed as follows:

Maximum retirement income level under section 37(e)(5)		$2,500
Earned income offset under section 37(e)(5)(B)(ii):		
Earned income in excess of $1,700	$950	
One-half of earned income in excess of $1,200, but not in excess of $1,700	250	1,200
Amount determined under section 37(e)(5)		1,300

Retirement income	2,400
Credit for the elderly (15 pct. of $1,300)	195

Example (2). During 1978 H, who is 67 years old, has earnings of $1,300 and retirement income (rents, interest, etc.) of $6,000. H also receives social security payments totalling $1,400. During 1978 W, who is 63 years old, earns $1,600 and receives a fully taxable pension of $1,400 from a public retirement system that constitutes retirement income. W performed the services giving rise to the pension. H and W file a joint return for 1978 and elect to compute the credit for the elderly under section 37(e). Under the applicable law these items of income are community income, and both spouses share equally in each item. Because H and W are filing a joint return, they disregard community property laws in computing their credit under section 37(e). The couple allocates $1,600 of the $3,750 referred to in section 37(e)(6) to W and $2,150 to H. Subject to the limitation of section 37(c)(2) and paragraph (b) of § 1.37-1, their credit for the elderly is $315, computed as follows:

Credit base of H:		
Amount allocated to H under section 37(e)(6)		$2,150
Reductions required by section 37(e)(5):		
Social Security payments	$1,400	
One-half of excess of earnings over $1,200	50	1,450
Amount determined under section 37(e)(5)		700
Retirement income		6,000
Credit base of H		700
Credit base of W:		
Amount allocated to W under section 37(e)(6)		$1,600
Reduction required by section 37(e)(5)(B):		
One-half of excess of earnings over $1,200		$200
Amount determined under section 37(e)(5)		1,400
Retirement income		1,400
Credit base of W		1,400
Computation of credit:		
Credit base of H		700
Credit base of W		1,400
Combined credit base		2,100
Credit for the elderly (15 pct. of $2,100)		315

Example (3). (a) Assume the same facts as in example (2) of this paragraph, except that H and W live apart at all times during 1978 and file separate returns. Under these circumstances, H and W must give effect to the applicable community property law in determining their credits under section 37(e). Thus, each spouse must take into account one-half of each item of income.

(b) Subject to the limitation of section 37(c)(2) and paragraph (b) of § 1.37-1, H's credit for the elderly is $157.50, computed as follows:

Maximum retirement income level under section 37(e)(7)		$1,875
Reductions required by section 37(e)(5):		
Social security payments	$700	
One-half of excess of earnings over $1,200 (taking into account one-half of combined earnings of $2,900)	125	825
Amount determined under section 37(e)(5)		1,050
Retirement income		3,700
Credit of H (15 pct. of $1,050)		157.50

(c) Subject to the limitation of section 37(c)(2) and paragraph (b) of § 1.37-1, W's credit for the elderly is computed as follows:

Maximum retirement income level under section 37(e)(7)		$1,875
Reductions required by section 37(e)(5):		
Social security payments	$700	
One-half of excess of earnings over $1,200	125	825
Amount determined under section 37(e)(5)		1,050
Retirement income (limited to W's share of public pension)		700
Credit of W (15 pct. of $700)		105

[T.D. 7743, 45 FR 84050, Dec. 22, 1980]

§ 1.38-1 Investment in certain depreciable property.

Regulations under sections 46 through 50 are prescribed under the authority granted the Secretary by section 38(b) to prescribe regulations as may be necessary to carry out the purposes of section 38 and Subpart B, Part IV, Subchapter A, Chapter 1 of the Code.

[44 FR 20417, Apr. 5, 1979]

§ 1.40-1 Expenses of work incentive program.

Sections 1.50A-1 through 1.50B-6, inclusive, are prescribed under the authority granted the Secretary or his delegate by section 40(b) of the Code to prescribe such regulations as may

be necessary to carry out the purposes of section 40 and Subpart C, Part IV, Subchapter A, Chapter 1 of the Code.

[T.D. 7263, 38 FR 6150, Mar. 7, 1973]

§ 1.41-0 Credit or deduction for political and newsletter fund contributions—scope and note.

Section 41 allows a limited credit against the income tax for political and newsletter fund contributions. Section 218 allows a limited deduction for contributions. The Revenue Act of 1978, however, increases the maximum annual credit under section 41 and repeals section 218. These changes are effective for political and newsletter fund contributions payment of which is made in taxable years of the contributor beginning after December 31, 1978. Section 1.41-1 through -8 apply to both sections 41 and 218.

[T.D. 7603, 44 FR 18222, Mar. 27, 1979]

§ 1.41-1 Same—definitions of certain items.

(a) *Campaign committee.* A "campaign committee" is any group described in section 41 (c) (1) (B). Thus, to be a campaign committee a group must be organized and operated exclusively to further the nomination or election of one or more candidates. That means it may not, except as otherwise provided in § 1.41-3(a), spend any money for any other purpose. Therefore, a group that engages in any general political, educational, or legislative activities is not a campaign committee. Such a group may, however, organize a separate campaign committee exclusively to further the nomination or election of one or more candidates.

(b) *Candidate.* A "candidate" is an individual described in section 41 (c)(2). A candidate remains a candidate until enough money has been raised to pay the debts incurred in a previous campaign for elective public office. For exmple, A, a candidate for Senator from State X in 1977, is elected to that office in 1978. A sustains a campaign debt with respect to A's Senatorial campaign. A remains a candidate solely for the purpose of soliciting contributions to extinguish the campaign debt.

(c) *Elective public office.* An "elective public office" is any governmental position for which one must be directly chosen by the casting of votes by the general public or the Electoral College. It does not, however, include any office or position in any national, state, or local political party or similar organization, or membership in the Electoral College.

(d) *Furthering a candidacy.* Expenditures further a candidacy within the meaning of section 41(c)(1) (A) and (B) if they are directly related to, and are intended to support, a candidate's campaign for elective public office. Examples include payments for—

(1) Researching and polling campaign issues;

(2) Trips in connection with campaigning by the candidate or persons acting on his or her behalf;

(3) Raising funds; and

(4) Campaign-related debts left over from a previous political campaign.

(e) *Meets the qualifications.* An individual "meets the qualifications prescribed by law" to hold an elective public office if the individual can be reasonably expected to meet those qualifications on or before the date the office is to be filled.

(f) *Newsletter fund contribution.* The term "newsletter fund contribution" means a contribution of money or gift of money directly to a fund described in section 527(g) (relating to the treatment of newsletter funds as political organizations).

(g) *Political contribution.* A "political contribution" is a contribution of money or gift of money directly to a person described in section 41(c)(1). A political contribution is not limited to that portion of the contribution or gift that is eligible as a credit under section 41(b) or deduction under section 218(b).

(h) *Publicly announces.* An individual "publicly announces" that he or she is a candidate by making a positive statement available for media distribution that he or she is seeking nomination or election to a specific elective public office. An example is a news release or other statement by an individual intended for distribution via television, radio, newspapers, or magazines within the geographic area associated

with the elective public office being sought which states that he or she seeks nomination or election to the office. Incumbency in an office does not constitute a public announcement that one is seeking reelection to that office. Furthermore, if because of death or any other reason an individual does not make a public announcement, the individual is not a candidate even though the individual was about to make a public announcement.

[T.D. 7603, 44 FR 18222, Mar. 27, 1979]

§ 1.41-2 Same—limitations and special rules.

(a) *When payment must be made.* A taxpayer may elect the credit under section 41 or the deduction under section 218 only if a political or newsletter fund contribution is actually paid within the taxable year for which the taxpayer claims the credit or deduction. The method of accounting the taxpayer uses and the date the contribution is pledged are irrelevant. Where a partnership makes a political or newsletter fund contribution, each partner is considered as having paid his or her distributive share of the political or newsletter fund contribution.

(b) *Campaign committee supporting more than one individual.* A section 41 credit or section 218 deduction may be available for a contribution of money to a campaign committee that supports, or intends to support, more than one candidate if at least one individual it supports is a candidate for the calendar year in which the contribution is made. However, if a taxpayer indicates at the time the contribution is made that it is for a specific individual, and that individual is not a candidate for the calendar year in which the contribution is made, no credit or deduction is available.

(c) *Examples.* The provisions of this section are illustrated by the following examples:

Example (1). B, an individual, makes a contribution of money in 1977 to the Good Government Committee, which is a campaign committee. The Good Government Committee supports C and D in 1977. C is a candidate for 1977. D is not a candidate for 1977. B may elect the credit under section 41 or deduction under section 218 for the contribution in 1977.

Example (2). Assume the same facts as in example (1), except that B earmarks the contribution solely to further the candidacy of D. B may not elect the credit under section 41 or deduction under section 218 for the 1977 contribution.

[T.D. 7603, 44 FR 18223, Mar. 27, 1979]

§ 1.41-3 Same—unspent contributions.

(a) *General rule.* Except as provided in paragraph (b) of this section, all unspent political contributions must be used within a reasonable period of time to make a deposit or contribution described in section 527 (d).

(b) *Special rules*—(1) *Candidates.* An individual who was a candidate may retain unspent political contributions in reasonable anticipation of using them solely to support his or her future candidacy for any Federal, State, or local elective public office.

(2) *Campaign committee.* A campaign committee may retain unspent political contributions in reasonable anticipation of using them to support the future candidacy of any individual for any Federal, State, or local elective public office.

[T.D. 7603, 44 FR 18223, Mar. 27, 1979]

§ 1.41-4 Same—procedure for electing a credit or deduction.

(a) *Scope note.* This section prescribes procedures for making the election under sections 41 and 218 to take either a credit or deduction for political and newsletter contributions.

(b) *How to elect.* A taxpayer elects the credit or deduction by making the appropriate entries on his or her income tax return for the taxable year in which the contribution is made.

(c) *Changing or revoking one's election.* The election may be changed or revoked. Thus, a taxpayer may change an election from credit to deduction or vice versa. In addition, if a taxpayer elects a credit or deduction for a particular taxable year to which, it later turns out, he or she is not entitled, the taxpayer must pay any additional tax that is due as a result. A taxpayer may change or revoke the election by use of an amended return.

[T.D. 7603, 44 FR 18223, Mar. 27, 1979]

§ 1.41-5 Same—verifications.

This section prescribes rules under sections 41(b)(3) and 218(b)(2) to tell a taxpayer how to verify political and newsletter fund contributions for which a credit or deduction is claimed. A taxpayer must have a written receipt to substantiate any claim that a contribution was made. A cancelled check, the payee of which is a person or fund described in section 41(c) (1) or (5), ordinarily meets this requirement. However, in appropriate cases, the Internal Revenue Service may require a taxpayer to furnish additional proof that the payee was a person or fund described in section 41(c) (1) or (5), or that the purpose of the payment was to make a political or newsletter fund contribution.

[T.D. 7603, 44 FR 18223, Mar. 27, 1979]

§ 1.41-6 Same—taxation of certain organizations.

See section 527 and the regulations thereunder for the tax treatment of a person or fund described in section 41(c) (1) or (5) that is treated as a section 527(e)(1) political organization.

[T.D. 7603, 44 FR 18223, Mar. 27, 1979]

§ 1.41-7 Same—transitional rule for past contributions.

A credit or deduction for a political contribution the payment of which was made before January 1, 1980 will be allowed if it meets the requirements for a credit or deduction under the notice of proposed rulemaking published on September 19, 1972 (37 FR 19140).

[T.D. 7603, 44 FR 18223, Mar. 27, 1979]

§ 1.41-8 Same—effective dates.

(a) *Political contributions.* Except as otherwise provided, these regulations apply to political contributions made in taxable years of the contributor beginning after December 31, 1971.

(b) *Newsletter fund contributions.* These regulations apply to newsletter fund contributions made in taxable years of the contributor beginning after December 31, 1974.

[T.D. 7603, 44 FR 18223, Mar. 27, 1979]

§ 1.42-1 Credit for personal exemptions for taxable years ending 1975.

(a) *Allowance of credit.* Subject to the limitation of paragraph (b) of this section, in the case of an individual, there shall be allowed as a credit against the tax imposed by chapter 1 for the taxable year, an amount equal to $30 multiplied by the total number of deductions for personal exemptions to which the individual is entitled for the taxable year under section 151 (b) and (e) and the regulations thereunder (relating to allowance of deductions for personal exemptions with respect to the taxpayer, his spouse, and dependents). For purposes of applying the preceding sentence, the total number of deductions for personal exemptions shall not include any additional exemptions to which the individual or his spouse may be entitled based upon age of 65 or more or blindness under section 151 (c) or (d) and the regulations thereunder.

(b) *Limitation.* The credit allowed by section 42 and paragraph (a) of this section shall not exceed the amount of tax imposed by chapter 1 for the taxable year.

(c) *Application with other credits.* In determining the credits allowed under—

(1) Section 33 (relating to foreign tax credit),

(2) Section 37 (relating to retirement income),

(3) Section 38 (relating to investment in certain depreciable property),

(4) Section 40 (relating to expenses of work incentive programs), and

(5) Section 41 (relating to contributions to candidates for public office),

the tax imposed by chapter 1 for the taxable year shall first be reduced (before any other reduction) by the credit allowed by section 42 and paragraph (a) of this section for the taxable year.

(d) *Effective dates.* The credit allowed by section 42 and paragraph (a) of this section shall apply only for taxable years ending after December 31, 1974, and before January 1, 1976.

[T.D. 7415, 41 FR 14369, Apr. 5, 1976, as amended by T.D. 7547, 43 FR 19653, May 8, 1978]

§ 1.42A-1 General tax credit for taxable years ending after December 31, 1975, and before January 1, 1979.

(a)(1) *Allowance of credit for taxable years ending after December 31, 1975, and beginning before January 1, 1977.* Subject to the special rules of paragraphs (b)(1), (c) and (d) and the limitation of paragraph (e)(1) of this section, an individual is allowed as a credit against the tax imposed by chapter 1 for the taxable year in the case of taxable years ending after December 31, 1975, and beginning before Januray 1, 1977, an amount equal to the greater of—

(i) 2 percent of so much of the individual's taxable income as does not exceed $9,000, or

(ii) $35 multiplied by the total number of deductions for personal exemptions to which the individual is entitled for the taxable year under section 151 (b) and (e) and the regulations thereunder (relating to allowance of deductions for personal exemptions with respect to the individual, the individual's spouse, and dependents).

For purposes of applying subdivision (ii) of this paragraph (a)(1), the total number of deductions for personal exemptions shall not include any additional exemptions to which the individual or his spouse may be entitled based upon age of 65 or more or blindness under section 151 (c) or (d) and the regulations thereunder.

(2) *Allowance of credit for taxable years beginning after December 31, 1976, and ending before Januray 1, 1979.* Subject to the special rules of paragraphs (b)(2), (c) and (d) and the limitation of paragraph (e)(2) of this section, an individual is allowed as a credit against the tax imposed by section 1, or against the tax imposed in lieu of the tax imposed by section 1, for the taxable year in the case of taxable years beginning after December 31, 1976, and ending before January 1, 1979, an amount equal to the greater of—

(i) 2 percent of so much of the individual's taxable income for the taxable year, reduced by the zero bracket amount determined under section 63 (d), as does not exceed $9,000, or

(ii) $35 multiplied by the total number of deductions for personal exemptions to which the individual is entitled for the taxable year under section 151 and the regulations thereunder (relating to allowance of deductions for personal exemptions).

(b) *Married individuals filing separate returns*—(1) *For taxable years ending after December 31, 1975, and beginning before January 1, 1977.* In the case of taxable years ending after December 31, 1975, and beginning before January 1, 1977, a married individual who files a separate return for the taxable year is allowed as a credit for the taxable year an amount equal to either—

(i) 2 percent of so much of the individual's taxable income as does not exceed $4,500, or

(ii) $35 multiplied by the total number of deductions for personal exemptions to which the individual is entitled for the taxable year under section 151 (b) and (e) and the regulations thereunder, but only if both the individual and the individual's spouse elect to have the credit determined in the manner described in this subdivision (ii) for their corresponding taxable years. The elections shall be made by both married individuals separately calculating and claiming the credit in the manner and amount described in this subdivision (ii) on their separate returns for their corresponding taxable years. The rules of section 142 (a) and the regulations thereunder (relating to individuals not eligible for the standard deduction) in effect for taxable years beginning before January 1, 1977, apply to determine whether the taxable years of the individual and the individual's spouse correspond to each other. For purposes of applying this subdivision (ii), the total number of deductions for personal exemptions shall not include any additional exemptions to which the individual may be entitled based upon age of 65 or more or blindness under section 151 (c) or (d) and the regulations thereunder.

(2) *For taxable years beginning after December 31, 1976, and ending before January 1, 1979.* In the case of taxable years beginning after December 31, 1976, and ending before January 1,

1979, a married individual who files a separate return for the taxable year shall determine the amount of the credit for the taxable year under section 42(a)(2) and § 1.42A-1(a)(2)(ii).

(3) *Determination of marital status.* For purposes of this paragraph, the determination of marital status shall be made as provided by section 143 and the regulations thereunder (relating to the determination of marital status).

(c) *Return for short period on change of annual accounting period.* In computing the credit provided by section 42 and this section for a period of less than 12 months (hereinafter referred to as a "short period"), where income is to be annualized under section 443(b)(1) in order to determine the tax—

(1) The credit allowed by paragraph (a)(1)(i) and (2)(i) of this section shall be computed based upon the amount of the taxable income annualized under the rules of section 443(b)(1) and § 1.443-1(b)(1), or

(2) (i) The credit allowed by paragraph (a)(1)(ii) of this section shall be computed based upon the total number of deductions for personal exemptions to which the individual is entitled for the short period under section 151 (b) and (e) and the regulations thereunder (relating to allowance of deductions for personal exemptions with respect to the individual, the individual's spouse, and dependents), and

(ii) The credit allowed by paragraph (a)(2)(ii) of this section shall be computed based upon the total number of deductions for personal exemptions to which the individual is entitled for the short period under section 151 and the regulations thereunder (relating to allowance of deductions for personal exemptions).

As so computed, the credit allowed by section 42 and this section shall be allowed against the tax computed on the basis of the annualized taxable income. See § 1.443-1(b)(1)(vi).

(d) *Certain persons not eligible*—(1) *Estates and trusts.* The credit provided by section 42 and this section shall not be allowed in the case of any estate or trust. Thus, the credit shall not be allowed to an estate of an individual in bankruptcy or to an estate of a deceased individual. However, in the case of a deceased individual, the credit shall be allowed on the decedent's final return filed by his executor or other representative. Also, the credit provided by section 42 and this section shall be allowed in the case of a return filed by an estate of an infant, incompetent, or an individual under a disability.

(2) *Nonresident alien individuals.* The credit provided by section 42 and this section shall not be allowed in the case of any nonresident alien individual. As used in this subparagraph, the term "nonresident alien individual" has the meaning provided by § 1.871-2. See, however, section 6013(g) for election to treat nonresident alien individual as resident of the United States. The credit shall be allowed to an alien individual who is a resident of the United States for part of the taxable year. See § 1.871-2(b) for rules relating to the determination of residence of an alien individual. For purposes of paragraph (a) (1)(i) and (2)(i) of this section, the credit allowed shall be computed by taking into account only that portion of the individual's taxable income which is attributable to the period of his residence in the United States. For purposes of paragraph (a)(1)(ii) of this section, the credit allowed shall be computed by taking into account only the total number of deductions for personal exemptions to which the individual is entitled under section 151 (b) and (e) for the period of his residence in the United States. For purposes of paragraph (a)(2)(ii) of this section, the credit allowed shall be computed by taking into account only the total number of deductions for personal exemptions to which the individual is entitled under section 151 for the period of his residence in the United States. See § 1.871-13 for rules relating to changes of residence status during a taxable year.

(e) *Limitation*—(1) *For taxable years ending after December 31, 1975, and beginning before January 1, 1977.* For taxable years ending after December 31, 1975, and beginning before January 1, 1977, the credit allowed by section 42 and this section shall not

exceed the amount of tax imposed by chapter 1 for the taxable year. In the case of an alien individual who is a resident of the United States for a part of the taxable year, the credit allowed by section 42 and this section shall not exceed the amount of tax imposed by chapter 1 for that portion of the taxable year during which the alien individual was a resident of the United States. See § 1.871-13.

(2) *For taxable years beginning after December 31, 1976, and ending before January 1, 1979.* For taxable years beginning after December 31, 1976, and ending before January 1, 1979, the credit allowed by section 42 and this section shall not exceed the amount of tax imposed by section 1, or the amount of tax imposed in lieu of the tax imposed by section 1, for the taxable year. In the case of an alien individual who is a resident of the United States for a part of the taxable year, the credit allowed by section 42 and this section shall not exceed the amount of tax imposed by section 1, or the amount of tax imposed in lieu of the tax imposed by section 1, for that portion of the taxable year during which the alien individual was a resident of the United States. See § 1.871-13.

(f) *Application with other credits.* In determining the credits allowed under—

(1) Section 33 (relating to foreign tax credit),

(2) Section 37 (relating to credit for the elderly),

(3) Section 38 (relating to investment in certain depreciable property),

(4) Section 40 (relating to expenses of work incentive programs), and

(5) Section 41 (relating to contributions to candidates for public office),

the tax imposed for the taxable year shall first be reduced (before any other reduction) by the credit allowed by section 42 and this section for the taxable year.

(g) *Income tax tables to reflect credit.* The tables prescribed under section 3 shall reflect the credit allowed by section 42 and this section.

(h) *Effective dates.* The credit allowed by section 42 and this section applies only for taxable years ending after December 31, 1975, and before January 1, 1979.

[T.D. 7547, 43 FR 19653, May 8, 1978]

§ 1.43-1 Earned income credit for taxable years beginning before January 1, 1979.

(a) *Allowance of credit.* For taxable years beginning before January 1, 1979 (and after December 31, 1974), subject to the limitations of paragraph (b) of this section, an eligible individual (as defined in paragraphs (c)(1) and (2) of this section) is allowed as a credit against the tax imposed by chapter 1 for the taxable year, and amount equal to 10 percent of the first $4,000 of earned income (as defined in paragraph (c)(3) of this section) for the taxable year. For later taxable years beginning after December 31, 1978, see § 1.43-2.

(b) *Limitations*—(1) *Amount of credit.* The amount of the credit allowed by section 43 and paragraph (a) of this section for the taxable year shall be reduced (but not below zero) by an amount equal to 10 percent of the excess over $4,000 of the greater of—

(i) The adjusted gross income (within the meaning of section 62 and the regulations thereunder) of the individual for the taxable year, or

(ii) The earned income (as defined in paragraph (c)(3) of this section) of the individual for the taxable year.

Thus, if the individual has adjusted gross income or earned income of $8,000 or more, he will not be entitled to the credit.

(2) *Married individuals.* No credit shall be allowed by section 43 and paragraph (a) of this section in the case of an eligible individual who is married (within the meaning of section 143 and the regulations thereunder) unless such individual and his spouse file a single return jointly for the taxable year (see section 6013 and the regulations thereunder relating to joint returns of income tax by husband and wife). The requirements of the preceding sentence shall not apply to an eligible individual who is not considered as married under section 143(b) and the regulations thereunder (relating to certain married individuals living apart).

(3) *Length of taxable year.* No credit shall be allowed by section 43 and paragraph (a) of this section in the case of a taxable year covering a period of less than 12 months. However, the rule of the preceding sentence shall not apply to a taxable year closed by reason of the death of the eligible individual.

(c) *Definition*—(1) *Eligible individual for taxable years beginning after December 31, 1974, and ending before Janurary 1, 1976.* For purposes of this section, with respect to taxable years beginning after December 31, 1974, and ending before Januray 1, 1976, an eligible individual is an individual who meets the following requirements of this subparagraph.

(i) For the entire taxable year, the individual maintains a household (within the meaning of section 44A(f)(1) and the regulations thereunder) in the United States, which household for the taxable year is the principal place of abode of that individual and of one or more of the children of that individual with respect to whom he is entitled to claim a deduction under section 151(e)(1)(B) and the regulation thereunder (relating to additional exemptions for dependents). The rules of § 1.152-1(b) and of section 44A(f)(1) and the regulations thereunder shall apply in determining whether such household is the principal place of abode of that individual and of one or more of his children. In addition, and only for purposes of determining a child's principal place of abode under this subparagraph, in the case of a child who is adopted during the taxable year (including a child who is placed with that individual during the taxable year by an authorized placement agency for legal adoption pursuant to a formal application filed by that individual with the agency) or who becomes that individual's stepchild during the taxable year, such household is only required to be the child's principal place of abode during that portion of the taxable year when he is that individual's child. However, in the case of a foster child who is treated as a child of the individual by blood under section 152(b)(2), such household is required to be the child's principal place of abode for the entire taxable year. The rules of this subdivision are illustrated by the following provisions which relate to members of the Armed Forces. A member of the United States Armed Forces who maintains his household outside the United States for any part of the taxable year is not an eligible individual. However, if he maintains his household within the United States for the entire taxable year and he is only temporarily absent therefrom by reason of military service and such household is the principal place of abode both of himself and of his child with respect to whom he is entitled to claim a deduction under section 151(e)(1)(B), then he will be an eligible individual if he meets the requirements of subdivision (ii) of this subpararaph.

(ii) For the entire taxable year, the individual is not entitled to exclude any amount from gross income under section 911 and the regulations thereunder (relating to earned income from sources without the United States) or section 931 and the regulations thereunder (relating to income from sources within the possessions of the United States).

(2) *Eligible individual for taxable years ending after December 31, 1975, and beginning before January 1, 1979.* For purposes of this section, with respect to taxable years ending after December 31, 1975, and beginning before January 1, 1979, an eligible individual is an individual who meets the following requirements of this subparagraph.

(i) For the entire taxable year, the individual maintains a household (within the meaning of section 44A(f)(1) and the regulations thereunder) in the United States.

(ii) For the entire taxable year, the household must be the principal place of abode of the individual. The household must also be the principal place of abode of one or more of the children of that individual who either have not attained the age of 19 at the close of the calendar year in which the taxable year of the individual begins or are students, or are disabled within the meaning of section 72(m)(7) and the regulations thereunder. However, a child of the individual who has at-

tained age 19, is not a student, and is disabled must be a child with respect to whom the individual is entitled to claim a deduction under section 151(e) and the regulations thereunder (relating to additional exemptions for dependents). For purposes of section 43 and this section, the children of the individual include a son, stepson, daughter, stepdaughter, adopted son, or an adopted daughter of the individual; a child who is placed with the individual by an authorized placement agency for legal adoption pursuant to a formal application filed by that individual with the agency; and a foster child of the individual. For purposes of this subdivision (ii), a foster child is a child who is in the care of a person or persons (other than the parents or adopted parents of the child) who care for the child as their own child. However, such a child is not a foster child if his natural or adopted parents provide over half of the child's support for their taxable year beginning in the calendar year in which the taxable year of the person or persons caring for the child begins. The rules of § 1.152-1(b) and of section 44A(f)(1) and the regulations thereunder shall apply in determining whether the household maintained by the individual is the principal place of abode of the individual and of one or more of his children. In addition, and only for purposes of determining a child's principal place of abode under this subparagraph, in the case of a child who is adopted during the taxable year (including a child who is placed with that individual during the taxable year by an authorized placement agency for legal adoption pursuant to a formal application filed by that individual with the agency) or who becomes that individual's stepchild during the taxable year such household is only required to be the child's principal place of abode during that portion of the taxable year when he is that individual's child. However, in the case of a foster child as defined in this subdivision (ii), such household is required to be the child's principal place of abode for the entire taxable year.

(iii) For the entire taxable year, the individual is not entitled to exclude any amount from gross income under section 911 and the regulations thereunder (relating to earned income from sources without the United States) or has made an election under section 911(e) for that section not to apply, and is not entitled to exclude any amount from gross income under section 931 and the regulations thereunder (relating to income from sources within the possessions of the United States).

(iv) The rules of this subparagraph are illustrated by the following examples:

Example (1). A, who is a member of the United States Armed Forces, maintains his household outside the United States for part of the taxable year. A is not an eligible individual. However, if A maintains his household within the United States for the entire taxable year and is only temporarily absent therefrom by reason of military service and if such household is his principal place of abode and the principal place of abode of his child who has not attained the age of 19 at the close of the calendar year in which the individual's taxable year begins or is a student, then the individual will be an eligible individual if he meets the requirements of subdivision (iii) of this subparagraph.

Example (2). B maintains his household within the United States for the entire taxable year. The household is B's principal place of abode and for the entire taxable year the principal place of abode of B's grandchild who is 12 years old and whose natural parents are deceased. The grandchild, who is not an adopted child, is in B's care and is cared for as B's own child. In these circumstances, the grandchild is B's foster child regardless of whether B provides sufficient support to claim the grandchild as a dependent and B will be an eligible individual if he meets the requirements of subdivision (iii) of this subparagraph.

Example (3). Assume the same facts as in example (2) except that the deceased parents have left an estate sufficient to provide for all or any part of the grandchild's material needs. In these circumstances, the grandchild is B's foster child and B will be an eligible individual if he meets the requirements of subdivision (iii) of this subparagraph.

Example (4). C maintains his household within the United States for the entire taxable year. The household is his principal place of abode and for the entire taxable year the principal place of abode of a 12 year old child whose natural parents are deceased and who is placed with C by a State agency to provide the child with foster care. C receives compensation from the State

agency to cover all of the cost of maintaining the child in his home. The child is in C's care and is cared for as C's own child. In these circumstances, the child is C's foster child and C will be an eligible individual if he meets the requirements of subdivision (iii) of this subparagraph.

Example (5). Assume the same facts as in example (4) except that C receives no compensation from the State agency. In these circumstances, the child is C's foster child regardless of whether C provides sufficient support to claim the child as a dependent and C will be an eligible individual if he meets the requirements of subdivision (iii) of this subparagraph.

Example (6). D maintains his household within the United States for the entire taxable year. The household is D's principal place of abode and for the entire taxable year the principal place of abode of D's nephew who is 15 years old. Although D cares for his nephew as his own child, the nephew's natural parents provide over half of his support. Since the nephew's natural parents provide over half of his support the nephew is not D's foster child and D is not an eligible individual.

Example (7). Assume the same facts as in example (6) except that the nephew's grandparents provide over half of his support. Since D's nephew's natural parents do not provide over half of his support, he is D's foster child and D will be an eligible individual if D meets the requirements of subdivision (iii) of this subparagraph.

(3) *Earned income.* For purposes of this section, earned income means—

(i) Wages, salaries, tips, other employee compensation, and

(ii) Net earnings from self-employment (within the meaning of section 1402(a) and the regulations thereunder)

which are includible in the eligible individual's gross income for the taxable year in which the credit is claimed. However, earned income shall be computed without regard to any community property laws which may otherwise be applicable. Earned income shall be reduced by any net loss in earnings from self-employment. Earned income shall not include amounts received as a pension or an annuity, an amount to which section 871(a) and the regulations thereunder apply (relating to income of nonresident alien individuals not connected with United States business), or an amount excluded from gross income under section 105 and the regulations thereunder (relating to amounts received under accident and health plans).

(d) *Example.* The application of this section is illustrated by the following example. For purposes of this example, assume that the eligible individual's adjusted gross income is equal to his earned income and that he does not receive a pension or an annuity, or an amount to which section 871(a), 911, or 931 applies.

Example. A and B (married individuals) maintain a household within the United States which is their principal place of abode and the principal place of abode of their two children who are 12 and 14 years old. A and B are calendar year taxpayers and, for 1977, they file a joint return. A and B have a total earned income of $7,500 (computed without regard to any community property laws) and have adjusted gross income of less than $7,500. The earned income credit of $50 is determined as follows:

Basic credit (10 pct. of $4,000 under paragraph (a) of this section)		$400
Less: Reduction under paragraph (b)(1) of this section:		
Earned income for taxable year	$7,500	
Less	4,000	
Excess earned income over $4,000	3,500	
10 pct. of excess ($3,500)		350
Total credit		50

(e) *Effective dates.* The rules of this section apply only for taxable years beginning both after December 31, 1974, and before January 1, 1979. For later taxable years beginning after December 31, 1978, see § 1.43-2.

[T.D. 7537, 43 FR 13877, Apr. 3, 1978, as amended by T.D. 7683, 45 FR 16175, Mar. 13, 1980]

§ 1.43-2 Earned Income credit for taxable years beginning after December 31, 1978.

(a) *Allowance of credit.* For taxable years beginning after December 31, 1978, subject to the limitations of paragraph (b) of this section, an eligible individual (as defined in paragraph (c)(1) of this section) is allowed as a credit against the tax imposed by subtitle A of the Code for the taxable

year, an amount equal to 10 percent of the first $5,000 of earned income (as defined in paragraph (c)(2) of this section) for the taxable year. For earlier taxable years beginning before January 1, 1979, see § 1.43-1.

(b) *Limitations*—(1) *Amount of credit.* The amount of the credit allowed by section 43 and paragraph (a) of this section for the taxable year must not exceed the excess, if any, of $500 over 12.5 percent of that amount of the adjusted gross income (or, if greater, the earned income) of the taxpayer for the taxable year which exceeds $6,000. For the meaning of the term "earned income," see paragraph (c)(2) of this section. Adjusted gross income is determined under section 62 and the regulations thereunder. If an individual has adjusted gross income or earned income of $10,000 or more, the individual is not entitled to the credit.

(2) *Married individuals.* No credit is allowed by section 43 and paragraph (a) of this section in the case of an eligible individual who is married (within the meaning of section 143 and the regulations thereunder) unless the individual and spouse file a single return jointly (a joint return) for the taxable year (see section 6013 and the regulations thereunder relating to joint returns of income tax by husband and wife). The requirements of the preceding sentence do not apply to an eligible individual who is not considered as married under section 143(b) and the regulations thereunder (relating to certain married individuals living apart).

(3) *Length of taxable year.* No credit is allowed by section 43 and paragraph (a) of this section in the case of a taxable year covering a period of less than 12 months. However, the rule of the preceding sentence does not apply to a taxable year closed by reason of the death of the eligible individual.

(c) *Definitions*—(1) *Eligible individual.* For purposes of this section, an eligible individual is an individual who meets the following requirements of this paragraph (c)(1).

(i) For the taxable year the individual must meet any one of the following three requirements set forth, respectively, in (A), (B), and (C) of this subdivision (i).

(A) The individual must be married (within the meaning of section 143 and the regulations thereunder) and be entitled to a deduction under section 151 for a child (within the meaning of section 151(e)(3) and the regulations thereunder). The child must have the same principal place of abode (as defined in § 1.2-2(c)) as the individual and that principal place of abode must be in the United States for the entire taxable year.

(B) The individual must qualify as a surviving spouse (as determined under section 2(a) and the regulations thereunder). Thus, the spouse of the individual must have died within the period of the 2 taxable years immediately preceding the individual's taxable year. Also, the individual must have furnished over half the cost of maintaining as the individual's home a household in the United States for the entire taxable year which is the principal place of abode of a child of the individual who qualifies as a dependent for whom the individual is entitled to a deduction under section 151.

(C) The individual must qualify as a head of household (as determined under section 2(b) and the regulations thereunder but without regard to section 2(b)(1)(A)(ii) and (B) and the regulations, thereunder). Thus, the individual cannot be married as of the close of the taxable year and also cannot qualify as a surviving spouse under section 2(a). Also, the individual must have furnished over half the cost of maintaining as the individual's home a household in the United States for the entire taxable year which is the principal place of abode of a child or descendant of the individual who is unmarried or who qualifies as a dependent for whom the individual is entitled to a deduction under section 151.

(ii) For the entire taxable year, the individual must not be entitled to exclude any amount from gross income under section 911 (relating to earned income by individuals in certain camps outside the United States) or section 931 and the regulations thereunder (relating to income from sources

within the possessions of the United States).

(iii) The rules of this paragraph (c)(1) are illustrated by the following examples:

Example (1). A, who is married and a member of the United States Armed Forces, maintains his household outside the United States for part of the taxable year. A is not an eligible individual. However, if A maintains his household inside the United States for the entire taxable year and is only temporarily absent therefrom by reason of military service and if the household is his principal place of abode and the principal place of abode of his child who receives over half of his support from the taxpayer for the calendar year in which the taxable year of the taxpayer begins and who either has less than $1,000 of gross income for the calendar year in which the individual's taxable year begins or who has not attained the age of 19 at the close of the calendar year in which the individual's taxable year begins or is a student, then the individual is an eligible individual if he meets the requirements of subdivision (ii) of this paragraph.

Example (2). B's wife died in 1975 and B has not remarried. For his entire taxable year beginning January 1, 1979, B maintains his household inside the United States. The household is, for the entire taxable year, B's principal place of abode and the principal place of abode of B's unmarried grandchild whose natural parents are deceased. Thus B qualifies as a head of household (as determined under section 2(b) without regard to subparagraphs (A)(ii) and (B) of section 2(b)(1)). In these circumstances, regardless of whether B provides sufficient support to claim the grandchild as a dependent, B is an eligible individual if he meets the requirements of subdivision (ii) of this paragraph.

Example (3). C is married and maintains his household inside the United States for the entire taxable year. The household is his principal place of abode and, for the entire year, is also the principal place of abode of a 12 year old child whose natural parents are deceased and who is placed with C by a State agency to provide the child with foster care. C receives compensation from the State agency to cover all of the cost of maintaining the child in his home. The child is in C's care and is cared for as C's own child. In these circumstances, the child is C's foster child, but C is not able to claim the child as a dependent since C did not provide half the child's support for the year. C is not eligible for the earned income credit.

Example (4). Assume the same facts as in exampe (3) except that C receives no compensation from the State agency, and C provides over half the child's support and is able to claim the child as a dependent. C is an eligible individual if he meets the requirements of subdivision (ii) of this paragraph.

Example (5). D's husband died in 1974 and D has not remarried. For the entire taxable year beginning January 1, 1979, D maintains her household inside the United States. The household is D's principal place of abode and, for the entire taxable year, is also the principal place of abode of D's unmarried son. D cares for her son in all respects except that her parents provide over half of the son's support. D qualifies as a head of household (as determined under section 2(b) without regard to subparagraph (A)(ii) and (B) of section 2(b)(1)). D is an eligible individual if D meets the requirements of subdivision (ii) of this paragraph.

Example (6). Assume the same facts as in example (5) except that D is married. Since D cannot qualify as a head of household, and D's son cannot be claimed as D's dependent, D is not an eligible individual.

(2) *Earned income.* For purposes of this section, earned income means—

(i) Wages, salaries, tips, other employee compensation, and

(iii) Net earnings from self-employment (within the meaning of section 1402(a) and the regulations thereunder).

Earned income includes compensation excluded from gross income, such as disability income excluded under section 105(d), the rental value of a parsonage excluded under section 107, and the value of meals and lodging furnished for the convenience of the employer excluded under section 119. Earned income is computed without regard to any community property laws which may otherwise be applicable. Earned income is reduced by any net loss in earnings from self-employment. Earned income does not include amounts received as a pension, an annuity, unemployment compensation, or workmen's compensation, or an amount to which section 871(a) and the regulations thereunder apply (relating to income of nonresident alien individuals not connected with United States business).

(d) *Examples.* The application of this section is illustrated by the following examples. For purposes of these examples, assume that the eligible individual does not receive a pension, an annuity, or an amount to which section 871(a), 911, or 931 applies.

Example (1). A and B (married individuals) maintain a household inside the United States which is their principal place of abode and the principal place of abode of their two children who are 12 and 14 years old. A and B are calendar year taxpayers and, for 1979, they file a joint return. A and B have a total earned income of $7,600 (computed without regard to any community property laws) and have adjusted gross income of less than $7,600. The earned income credit of $300 is determined as follows:

Basic credit (10 percent of $5,000 under paragraph (a) of this section			$500
Initial limitation amount		$500	
Less: Reduction under paragraph (b)(1) of this section:			
Earned income for taxable year	$7,600		
Less	$6,000		
Excess over $6,000	1,600		
12½ percent of excess ($1,600)		$200	
Maximum credit (if less than basic credit)			$300

Example (2). Assume the same facts as in example (1) except that A and B have earned income of $4,000 and adjusted gross income of $7,000. The earned income credit of $375 is determined as follows:

Basic credit (10 percent of $4,000 under paragraph (a) of this section)			$400
Initial limitation amount		$500	
Less: Reduction under paragraph (b)(1) of this section:			
Adjusted gross income for taxable year	$7,000		
Less	6,000		
Excess over $6,000	1,000		
12½ percent of excess ($1,000)		125	
Maximum credit (if less than basic credit)			375

(e) *Coordination of credit with advance payments*—(1) *Recapture of excess advance payments.* If any advance payment of earned income credit under section 3507 is made to an individual by an employer during any calendar year, then the total amount of these advance payments to the individual in that calendar year is treated as an additional amount of tax imposed (by chapter 1 of the Code) upon the individual on the tax return for the individual's last taxable year beginning in that calendar year.

(2) *Reconciliation of payments advanced and credit allowed.* Any additional amount of tax under paragraph (e)(1) of this section is not treated as a tax imposed by chapter 1 of the Code for purposes of determining the amount of any credit (other than the earned income credit) allowable under subpart A, part IV, subchapter A, chapter 1 of the Code.

[T.D. 7683, 45 FR 16175, Mar. 13, 1980]

§ 1.44-1 Allowance of credit for purchase of new principal residence after March 12, 1975, and before January 1, 1977.

(a) *General rule.* Section 44 provides a credit against the tax imposed by chapter 1 of the Internal Revenue Code of 1954 in the case of an individual who purchases a new principal residence (as defined in paragraph (a) of § 1.44-5) which is property to which section 44 applies (as provided in § 1.44-2). Subject to the limitations set forth in paragraph (b) of this section, the credit is in an amount equal to 5 percent of the purchase price (as defined in paragraph (b) of § 1.44-5).

(b) *Limitations*—(1) *Maximum credit.* The credit allowed under section 44 and this section may not exceed $2,000.

(2) *Limitation to one residence.* Such credit shall be allowed with respect to only one residence of the taxpayer; the combined purchase prices of more than one new principal residence cannot be aggregated to increase the credit allowed.

(3) *Married individuals.* In the case of a husband and wife who file a joint return under section 6013, the maximum credit allowed on the joint return is $2,000. In the case of married individuals filing separate returns the maximum credit allowable to each spouse is $1,000. Where a husband and wife do not make equal contributions with respect to the purchase price of the new principal residence, allocation of the credit is to be made in proportion to their respective ownership interests in such residence. For this purpose, tenants by the entirety or joint tenants with right of survivorship are treated as equal owners.

(4) *Certain other taxpayers.* Where a new principal residence is purchased by two or more taxpayers (other than a husband and wife), the amount of the credit allowed will be allocated among the taxpayers in proportion to their respective ownership interests in such residence, with the limitation that the sum of the credits allowed to all such taxpayers shall not exceed $2,000. For this purpose, joint tenants with right of survivorship are treated as equal owners. For an example of the operation of this provision see example (2) of § 1.44-5(b)(2)(ii).

(5) *Application with other credits.* The credit allowed by this section shall not exceed the amount of the tax imposed by chapter 1 of the Code for the taxable year, reduced by the sum of the credits allowable under—

(i) Section 33 (relating to taxes of foreign countries and possessions of the United States),

(ii) Section 37 (relating to retirement income),

(iii) Section 38 (relating to investment in certain depreciable property),

(iv) Section 40 (relating to expenses of work incentive program),

(v) Section 41 (relating to contributions to candidates for public office), and

(vi) Section 42 (relating to personal exemptions).

[T.D. 7391, 40 FR 55851, Dec. 2, 1975]

§ 1.44-2 Property to which credit for purchase of new principal residence applies.

The provisions of section 44 and the regulations thereunder apply to a new principal residence which satisfies the following conditions:

(a) *Construction.* The construction of the residence must have begun before March 26, 1975. For this purpose construction is considered to have commenced in the following circumstances:

(1)(i) Except as provided in subparagraph (2) of this paragraph, construction is considered to commence when actual physical work of a significant amount has occurred on the building site of the residence. A significant amount of construction requires more than drilling to determine soil conditions, preparation of an architect's sketches, securing of a building permit, or grading of the land. Land preparation and improvements such as the clearing and grading (excavation or filling), construction of roads and sidewalks, and installation of sewers and utilities are not considered commencement of construction of the residence even though they might involve a significant expenditure. However, driving pilings for the foundation, digging of the footings, excavation of the building foundation, pouring of floor slabs, or construction of compacted earthen pads when specifically prepared and designed for a particular residential structure and not merely as a part of the overall land preparation, constitute a significant amount of construction of the residence. In the case of a housing or condominium development construction of recreational facilities no matter how extensive does not by itself constitute commencement of construction of any residential unit. However, where residential units are part of a building structure, as in the case of certain condominium and cooperative housing units, then digging of the footings or excavation of the building foundation constitutes commencement of construction for all units in that building.

(ii) The rules in subdivision (i) of this subparagraph are illustrated by the following examples:

Example (1). A location chosen for a housing development has extremely hilly terrain. In order to make the location suitable for development, the builder moves large amounts of earth and places it elsewhere on the location. In addition, the earth material which has been moved must be compacted according to government specifications in order to provide a stable base. Such activities constitute land preparation and, therefore, do not constitute the commencement of construction.

Example (2). A location chosen for a housing development has swampy and marshy terrain. In order to make the location suitable for development the builder utilizes large quantities of fill. This activity constitutes land preparation and does not constitute commencement of construction.

Example (3). Assume the same facts as in either example (1) or example (2) except that the builder also constructs an earthen pad of compacted fill specifically prepared for a particular residential structure and not merely as a part of the overall land

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preparation. Construction of the compacted earthen pad is considered in the same light as excavation of the building foundation and accordingly constitutes commencement of construction.

(2) Construction of a factory-made home (as defined in paragraph (e) of § 1.44-5) is considered to have commenced when construction of important parts of the factory-made home has commenced. For this purpose, commencement of construction of important parts means the cutting and shaping or welding of structural components for a specific identifiable factory-made home, whether the work was done by the manufacturer of the home or by a subcontractor thereof.

(b) *Acquisition and occupancy.* The residence must be acquired and occupied by the taxpayer after March 12, 1975, and before January 1, 1977. For this purpose a taxpayer "acquires" a residence when legal title to it is conveyed to him at settlement, or he has possession of it pursuant to a binding purchase contract under which he makes periodic payments until he becomes entitled under the contract to demand conveyance of title. A taxpayer "occupies" a residence when he or his spouse physically occupies it. Thus, for example, moving of furniture or other household effects into the residence or physical occupancy by a dependent child of the taxpayer is not "occupancy" for purposes of this paragraph. The credit may be claimed when both the acquisition and occupancy tests have been satisfied. Thus, where a taxpayer meets the acquisition and occupancy tests set forth above after March 12, 1975, and before January 1, 1976, the credit is allowable for 1975. Where a taxpayer occupied a residence prior to March 13, 1975, without having acquired it (as where his occupancy was pursuant to a leasing arrangement pending settlement under a binding contract to purchase or pursuant to a leasing arrangement where a written option to purchase was contained in the original lease agreement) he will nonetheless satisfy the acquisition and occupancy tests set forth above if he acquires the residence and continues to occupy it after March 12, 1975, and before January 1, 1977.

(c) *Binding contract.* Except in the case of self-construction, the new principal residence must be acquired by the taxpayer (within the meaning of paragraph (b) of this section) under a binding contract entered into by the taxpayer before January 1, 1976. An otherwise binding contract for the purchase of a residence which is conditioned upon the purchaser's obtaining a loan for the purchase of the residence (including conditions as to the amount or interest rate of such loan) is considered binding notwithstanding that condition.

(d) *Self-constructed residence.* A self-constructed residence (as defined in paragraph (d) of § 1.44-5) must be occupied by the taxpayer before January 1, 1977. Where self-construction of a principal residence was begun before March 13, 1975, only that portion of the basis of the property allocable to construction after March 12, 1975, and before January 1, 1977, shall be taken into consideration in determining the amount of the credit allowable. For this purpose, the portion of the basis attributable to the pre-March 13 period includes the total cost of land acquired (as defined in paragraph (b) of this section) prior to March 13, 1975, on which the new principal residence is constructed and the cost of expenditures with respect to construction work performed prior to March 13, 1975. The costs incurred in stockpiling materials for later stages of construction, however, are not allocated to the pre-March 13 period. Thus, for example, if prior to March 13, 1975, a taxpayer who qualifies for the credit has constructed a portion of a residence at a cost of $10,000 (including the cost of the land purchased prior to March 13, 1975) and the total cost of the residence is $40,000 and the taxpayer's basis after the application of section 1034(e) (relating to the reduction of basis of new principal residence where gain is not recognized upon the sale of the old residence) is $36,000, the amount subject to the credit will be $27,000:

($30,000 ÷ $40,000) × $36,000.

[T.D. 7391, 40 FR 55852, Dec. 2, 1975; 40 FR 58138, Dec. 15, 1975]

§ 1.44-3 Certificate by seller.

(a) *Requirement of certification by seller.* Taxpayers claiming the credit should attach Form 5405, Credit for Purchase or Construction of New Principal Residence, to their tax returns on which the credit is claimed. Except in the case of self-construction (as defined in § 1.44-5(d)), taxpayers must attach a certification by the seller that construction of the residence began before March 26, 1975, and that the purchase price is the lowest price at which the residence was offered for sale after February 28, 1975. For purposes of section 44(e)(4) and this section, the term "price" generally does not include costs of acquisition other than the amount of the consideration from the purchaser to the seller. However, for rules relating to adjustments in price due to changes in financing terms and closing costs see paragraph (d)(2) of this section.

(b) *Form of certification.* The following form of the certification statement is suggested:

I certify that the construction of the residence at (specify address) was begun before March 26, 1975, and that this residence has not been offered for sale after February 28, 1975 in a listing, a written private offer, or an offer by means of advertisement at a lower purchase price than (state price), the price at which I sold the residence to (state name, present address, and social security number of purchaser) by contract dated (give date).

(Date, seller's signature and taxpayer identification number.)

However, any written certification filed by the taxpayer will be accepted provided that such certification is signed by the seller and states that construction of the residence began before March 26, 1975, and that the purchase price of the residence is the lowest price at which the residence was offered for sale after February 28, 1975. With regard to factory-made homes the seller, in the absence of his own knowledge as to the commencement of construction, may attach to his own certification a certification from the manufacturer that construction began before March 26, 1975, and may certify based on the manufacturer's certification. It is suggested that both certifications include the serial number, if any, of the residence.

(c) *Offer to sell.* (1) For purposes of section 44(e)(4) and this section, an offer to sell is limited to an offer to sell a specified residence at a specified purchase price.

(2) An "offer" includes any written offer, whether made to a particular purchaser or to the public, and any offer by means of advertising. Advertising includes an offer to sell published by billboards, flyers, brochures, price lists (unless the lists are exclusively for the internal use of the seller and are not made available to the public), mailings, newspapers, periodicals, radio, or television. The listing of a property with a real estate agency, the filing of a prospectus and the registration of construction plans and price lists with the appropriate authorities (in the case of condominiums or cooperative housing developments) are to be considered offers made to the public.

(3) An offer to sell a specified residence includes:

(i) Both an offer to sell an existing residence and an offer to build and sell a residence of substantially the same design or model as that purchased by the taxpayer on the same lot as that on which the taxpayer's new principal residence was constructed. It does not include an offer to sell the same model residence on a different lot. Where a residence of a particular design or model is offered at a specific base price, additions of property to the residence, no matter how extensive, will not result in the residence being treated as a different residence for the purpose of determining the lowest offer (as defined in paragraph (f) of § 1.44-5).

(ii) In the case of a condominium or cooperative housing development where units are offered for sale on the basis of models (*e.g.*, all Model C two-bedroom apartments sell at a specified base price), an offer to sell a specified residence includes an offer to sell a specific type of unit (with appropriate adjustments to be made for the loca-

tion of such unit and as provided in paragraph (d) of this section).

(iii) In the case of a factory-made home, an offer to sell a specified residence includes an offer to sell the same model home as that purchased by the taxpayer, provided that the offer is made after the seller has the right to sell the home purchased by the taxpayer (*i.e.*, has that specific home in his inventory). However, it does not include an offer to sell such home with land which is not included in the taxpayer's purchase nor an offer to sell such home without land which is included in the taxpayer's purchase. Appropriate adjustments to a prior offer shall be made as provided in paragraph (d) of this section, including adjustments for any delivery and installation charges as provided in paragraph (d)(3).

(iv) The rules of this subparagraph may be illustrated by the following examples:

Example (1). In March 1975 A advertised colonial-style homes on section I of subdivision C at a base price of $40,000. At the time none of the homes had been completed but construction of all homes on section I was commenced before March 26, 1975. After one-half of the homes were sold, A offers to sell the remaining homes in May 1975 at a base price of $45,000. Under the facts above the base price of $45,000 is not the lowest offer since the seller had offered to sell the same model home on the same lot at a lower purchase price after February 28, 1975.

Example (2). In June 1975 A offers houses, otherwise qualifying, on section II for the first time for a base price of $50,000. They are colonial homes and substantially the same as the homes he previously offered on section I. Under the facts stated above the base price of $50,000 is the lowest offer since the same model home on the same lot was not previously offered for sale.

Example (3). In March 1975 B, a condominium developer, offers to sell any two-bedroom unit in a particular high rise condominium for $45,000 with an added $5,000 for units with a lake front view and an additional $2,000 for units on higher floors. With regard to all two-bedroom units in the condominium an offer to sell a specified residence at a specified purchase price has been made. This is true even though at the time of the offer construction had not reached the floor on which the particular unit will be located.

(4) A specified purchase price means a stated definite price for a particular residence or a specific base price for a residence of a particular model or design. An offer to sell for an indefinite price (*e.g.*, an advertisement that all houses sell in the $40,000's) is not considered an offer to sell at a specified purchase price.

(5) An offer to sell includes an offer to sell subject to special conditions imposed by the seller. Thus, if the lowest price at which a house was advertised was "at $40,000 for March only", the $40,000 price would be the lowest offer. However, certain conditions may necessitate adjustments in determining the lowest offer. See paragraph (d) of this section.

(6) An offer to sell two or more residences together as for example, in a bulk sale shall be disregarded, even though each residence is assigned a specific purchase price for the purpose of such a sale. With regard to factory-made homes an offer to sell does not include an offer made by the manufacturer to a dealer in such homes.

(7)(i) Where new residences are purchased at a foreclosure sale (including a conveyance by the owner in lieu of foreclosure) and prior to the foreclosure sale such residences had been offered for sale by the foreclosure seller at specified prices, the foreclosure purchaser is bound by such prices in determining the lowest offer. He is not bound by the prices paid to the foreclosure seller since such prices do not constitute voluntary offers.

(ii) For this purpose, if the foreclosure seller and foreclosure purchaser are not related parties (as defined in subdivision (iii) of this subparagraph), and if the foreclosure purchaser does not have knowledge of the date of commencement of construction and the lowest offer made by such seller with respect to each of the foreclosed residences, the foreclosure purchaser must request and try to obtain from the foreclosure seller a certificate specifying such facts. Upon a subsequent sale of a particular residence by the foreclosure purchaser, he must certify whether the price is the lowest offer for that particular residence based on the certification of the foreclosure seller, a copy of which must be attached to the certification of the foreclosure purchaser. If the foreclo-

sure seller refuses to so certify, the foreclosure purchaser must make a reasonable effort to determine the date construction commenced and the lowest offer made by the foreclosure seller. For this purpose, reasonable effort includes the effort to locate and examine advertising and listings published or used by the foreclosure seller. If the foreclosure seller and foreclosure purchaser are related parties (as defined in subdivision (iii) of this subparagraph), the foreclosure purchaser will be considered as having knowledge of the date of the commencement of construction and the lowest offer made by such seller with respect to each of the foreclosed residences, and, upon a subsequent sale of a particular residence by the foreclosure purchaser, he must comply with the certification requirements prescribed by paragraphs (a) and (b) of this section.

(iii) For purposes of this subparagraph related parties shall include the relationships described in subparagraph (2) of § 1.44–5(c), and the constructive ownership rules of section 318 shall apply, but family members for this purpose shall include spouses, ancestors, and lineal descendants.

(d) *Adjustments in determining lowest price.* (1)(i) In determining whether a residence was sold at the lowest offer appropriate adjustment shall be made for differences in the property offered and in the terms of the sale. Where the sale to the taxpayer includes property which was not the subject of the prior offer or excludes property which was included in the prior offer, the amount of the prior offer shall be adjusted to reflect the fair market value of such property, provided that, in the case of property included in the sale which was not a part of the residence at the time of execution of the contract of purchase, the taxpayer had the option to require inclusion or exclusion of such property. The fair market value of any excluded property is to be determined at the time of the prior offer, while all additions are to be valued at their fair market value on the date of execution of the contract of sale. If a seller increases his present offer to include financing or other costs of the seller in connection with his ownership of the residence, the present offer does not qualify as being the lowest offer.

(ii) The rules in subdivision (i) of this subparagraph are illustrated by the following examples:

Example (1). A offered to sell a new home without a garage for $35,000. Having found no buyers A added a garage and sold the home for $40,000. At the time the contract of sale was executed the fair market value of the garage was $5,000. The offer to sell for $40,000 qualifies since it equals the seller's lowest offer plus the fair market value of the garage.

Example (2). B, unable to sell colonial-style homes presently under construction and previously offered for sale for $40,000, makes extensive changes in decor and identifies the homes as his new Williamsburg model. The Williamsburg models are not different residences for purposes of this section. To the extent that the additions have not yet been added at the time of execution of a contract of sale, in order to qualify for the credit the taxpayer must have the option as to whether to include these additions, and if these additions are included B must charge no more than the fair market value of the additions on that date of execution of the contract of sale.

(2) Appropriate adjustment to a prior offer to sell shall be made for differences in financing terms and closing costs which increase the seller's actual net proceeds and the purchaser's actual costs. A seller may pass on to the purchaser without affecting the purchase price only those additional amounts he is required to expend in connection with such differences. The seller may not by changing the financing terms or closing costs indirectly increase the purchase price. For these purposes closing costs include all charges paid at settlement for obtaining the mortgage loan and transferring real estate title. Thus, for example, where a seller previously offered a residence for sale for $40,000 and agreed to pay financing "points" required by the mortgagee, and now offers the same residence also for $40,000 but requires the purchaser to pay the points, the present offer does not constitute the lowest offer. On the other hand, a prior offer to sell based upon a large down payment by the prospective purchaser may be adjusted to reflect the additional costs to the

seller of accepting a small down payment from the taxpayer. For purposes of determining the seller's net proceeds, proceeds received by all related parties within the meaning of section 318 must be taken into account. For purposes of determining the lowest offer, where an offer provided for a rebate (*e.g.*, of cash or of a contribution toward mortgage payments) or included, without additional charge or at less than fair market value, property not normally included in the sale of a residence (*e.g.*, an automobile), such offer must be reduced by the amount of such rebate or by the amount by which the fair market value of such property at the time of the offer exceeds the amount paid for it by the purchaser. Thus, where a residence was advertised for sale at $40,000, but the seller agreed to pay $200 a month on the purchaser's mortgage for 10 months, such residence is considered to have been offered for sale at $38,000.

(3) In the case of a factory-made home, where delivery and installation costs are included in the specified base price of such home an appropriate adjustment is to be made in such specified base price for differences in the fair market value of the delivery and installation in determining the lowest offer.

(e) *Civil and criminal penalties.* If a person certifies that the price for which the residence was sold does not exceed the lowest offer and if it is found that the price for which the residence was sold exceeded the lowest offer, then such person is liable (under section 208(b) of the Tax Reduction Act of 1975) to the purchaser for damages in an amount equal to three times the excess of the certified price over the lowest offer plus reasonable attorney's fees. No income tax deduction shall be allowed for two- thirds of any amount paid or incurred pursuant to a judgment entered against any person in a suit based on such liability. However, attorney's fees, court costs, and other such amounts paid or incurred with respect to such suit which meet the requirements of section 162 are deductible under that section. In addition, an individual who falsely certifies may be subject to criminal penalties. For example, section 1001 of title 18 of the United States Code provides as follows:

§ 1001. Statements or entries generally.

Whoever, in any matter within the jurisdiction of any department or agency of the United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined not more than $10,000 or imprisoned not more than five years, or both.

The treble damages and criminal sanctions provided under this paragraph apply only with regard to false certification as to the lowest offer, not to false certification as to commencement of construction. However, with regard to false certification as to commencement of construction there may exist contractual or tort remedies under State law.

(f) *Denial of credit.* In the absence of the taxpayer's participation in, or knowledge of, a false certification by the seller, the credit is not denied to a taxpayer who otherwise qualifies for the credit solely because the seller has falsely certified that the new principal residence was sold at the lowest offer. However, if certification as to the commencement of construction is false, no credit is allowed since such residence does not qualify as a new principal residence construction of which began before March 26, 1975.

[T.D. 7391, 40 FR 55852, Dec. 2, 1975]

§ 1.44-4 Recapture for certain dispositions.

(a) *In general.* (1) Under section 44(d) except as provided in paragraphs (b) and (c) of this section, if the taxpayer disposes of property, with respect to the purchase of which a credit was allowed under section 44(a), at any time within 36 months after the date on which he acquired it (or, in the case of construction by the taxpayer, the date on which he first occupied it as his principal residence), then the tax imposed under chapter 1 of the Code for the taxable year in which the replacement period (as provided

under subparagraph (2) of this paragraph) terminates is increased by an amount equal to the amount allowed as a credit for the purchase of such property.

(2) The replacement period is the period provided for purchase of a new principal residence under section 1034 of the Code without recognition of gain on the sale of the old residence. In the case of residences sold or exchanged after December 31, 1974, it is generally 18 months in the case of acquisition by purchase and 2 years in the case of construction by the taxpayer provided, however, that such construction has commenced within the 18-month period. Thus, a calendar-year taxpayer who disposes of his old principal residence in December 1975 and does not qualify under paragraph (b) or (c) of this section will include the amount previously allowed as additional tax on his 1977 tax return.

(3) Except as provided in paragraphs (b) and (c) of this section, section 44(d) applies to all dispositions of property, including sales (including foreclosure sales), exchanges (including tax-free exchanges such as those under sections 351, 721, and 1031), and gifts.

(4) In the case of a husband and wife who were allowed a credit under section 44(a) claimed on a joint return, for the purpose of section 44(d) and this section the credit shall be allocated between the spouses in accordance with the provisions of paragraph (b)(3) of § 1.44-1.

(b) *Acquisition of a new residence.* (1) Section 44(d)(1) and paragraph (a) of this section shall not apply to a disposition of property with respect to the purchase of which a credit was allowed under section 44(a) in the case of a taxpayer who purchases or constructs a new principal residence (within the meaning of § 1.44-5(a)) within the applicable replacement period provided in section 1034. In determining whether a new principal residence qualifies for purposes of this section the rules relating to construction, acquisition, and occupancy under § 1.44-2 do not apply. Where a disposition has occurred and the taxpayer's purchase (or construction) costs of a new principal residence are less than the adjusted sales price (as defined in section 1034(b)) of the old residence, the tax imposed by chapter 1 of the Code for the taxable year following the taxable year during which disposition occurs is increased by an amount which bears the same ratio to the amount allowed as a credit for the purchase of the old residence as (i) the adjusted sales price of the old residence (within the meaning of section 1034), reduced (but not below zero) by the taxpayer's cost of purchasing (or constructing) the new residence (within the meaning of such section) bears to (ii) the adjusted sales price of the old residence.

(2) The rules of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. On July 15, 1975, A purchases a new principal residence for a total purchase price of $40,000. The property meets the tests of § 1.44-2, and A is allowed a credit of $2,000 on his 1975 tax return. On January 15, 1977 (within 36 months after acquisition) A sells his residence for an adjusted sales price of $50,000 and on March 15, 1977, purchases a new principal residence at a cost of $40,000. Since the new principal residence was purchased within the 18-month replacement period (provided in section 1034), the amount recaptured is limited to $400, determined by multiplying the amount of the credit allowed ($2,000) by a fraction, the numerator of which is $10,000 (determined by reducing the adjusted sales price of the old residence ($50,000) by A's cost of purchasing the new principal residence ($40,000)) and the denominator of which is $50,000 (the adjusted sales price). Therefore, A's tax liability for 1978, the year following the taxable year in which the disposition occurred, is increased by $400.

(c) *Certain involuntary dispositions.* Section 44(d)(1) and paragraph (a) of this section shall not apply to the following:

(1) A disposition of a residence made on account of the death of any individual having a legal or equitable interest therein occurring during the 36-month period described in paragraph (a) of this section.

(2) A disposition of the residence if it is substantially or completely destroyed by a casualty described in section 165(c)(3).

(3) A disposition of the residence if it is compulsorily and involuntarily

converted within the meaning of section 1033(a), or

(4) A disposition of the residence pursuant to a settlement in a divorce or legal separation proceeding where the other spouse retains the residence as principal residence (as defined in § 1.44-5(a)).

[T.D. 7391, 40 FR 55854, Dec. 2, 1975; 40 FR 58138, Dec. 15, 1975]

§ 1.44-5 Definitions.

For purposes of section 44 and the regulations thereunder—

(a) *New principal residence.* The term "new principal residence" means a principal residence, the original use of which commences with the taxpayer. The term "principal residence" has the same meaning as under section 1034 of the Code. For this purpose, the term "residence" includes, without being limited to, a single family structure, a residential unit in a condominium or cooperative housing project, a townhouse, and a factory-made home. In the case of a tenant-stockholder in a cooperative housing corporation references to property used by the taxpayer as his principal residence and references to the residence of a taxpayer shall include stock held by the tenant-stockholder in a cooperative housing project provided, however, that the taxpayer used as his principal residence the house or apartment which he was entitled as such stockholder to occupy. "Original use" of the new principal residence by the taxpayer means that such residence has never been used as a residence prior to its use as such by the taxpayer. For this purpose, a residence will qualify if the first occupancy was by the taxpayer pursuant to a lease arrangement pending settlement under a binding contract to purchase or pursuant to a lease arrangement where a written option to purchase the then existing residence was contained in the original lease agreement.

A renovated building does not qualify as new, regardless of the extent of the renovation nor does a condominium conversion qualify.

(b) *Purchase price*—(1) *General rule.* For purposes of section 44(a) and § 1.44-1, the term "purchase price" means the adjusted basis of the new principal residence on the date of acquisition and includes all amounts attributable to the acquisition or construction, but only to the extent that such amounts constitute capital expenditures and are not allowable as deductions in computing taxable income. Such capital expenditures include but are not limited to the cost of acquisition or construction, title insurance, attorney's fees, transfer taxes, and other costs of transfer. For these purposes the adjusted basis of a factory-made home includes the cost of moving the home and setting it up as the taxpayer's principal residence only where such cost is included in the base price of the residence; it also includes the purchase price of the land on which the home is located, but only if such land was purchased by the taxpayer after March 12, 1975 and only if the taxpayer acquired the land prior to or in conjunction with the acquisition of such factory-made home. However, the adjusted basis does not include any expenditures involved in connection with the leasing of land on which the factory-made home is located. In the case of factory-made homes the adjusted basis includes furniture only where it is included in the base price of the unit.

(2) *Sale of old principal residence.* (i) The adjusted basis is reduced by any gain from the sale or involuntary conversion of an old principal residence, which is not recognized due to the application of section 1033 or section 1034. However, no reduction will be made for any gain excluded from tax by reason of the special treatment provided under the tax laws in the case of a sale by a taxpayer who has attained age 65 (sec. 121 of the code).

(ii) The rules in subdivision (i) of this subparagraph are illustrated by the following examples:

Example (1). A sells an old principal residence for $30,000 which has an adjusted basis of $20,000. A reinvests the proceeds by purchasing a new principal residence for $40,000 (including settlement costs which are capital in nature), and this purchase satisfies the statutory criteria under section 1034 for nonrecognition of gain. The credit under section 44 applies with respect to $30,000 ($40,000 costs minus $10,000 unre-

cognized gain) of the cost of the new principal residence.

Example (2). B and C, two sisters, purchase a new principal residence as joint tenants with the right of survivorship for a total purchase price of $40,000. B has previously sold her old principal residence for $25,000 and a $10,000 gain on the sale has qualified for nonrecognition under section 1034. B contributes $25,000 and C contributes $15,000. The adjusted basis of the new principal residence is $30,000 representing the total purchase price of $40,000 less $10,000 representing unrecognized gain under section 1034. The total credit allowable, therefore, is $1,500. Since joint tenants are treated as equal owners and since allocation of the credit is made in proportion to the taxpayer's respective ownership interests in such residence B and C each will receive a credit of $750.

Example (3). Taxpayer D is 65 years old and sells his old principal residence for $20,000 excluding all gain under section 121. He then purchases a new principal residence for $30,000. D's adjusted basis in his new principal residence is $30,000, and he is allowed a credit of $1,500.

(3) *Tie-in sales.* In the case of a purchase of a new principal residence which is tied in to the transfer of other property by the seller to the purchaser, whether purportedly by sale or gift, the adjusted basis of the residence is reduced by the amount of the excess of the fair market value of such other property received over the amount, if any, purportedly paid for it by the purchaser of the residence. For example, if a taxpayer receives a new car with a fair market value of $2,500 upon the purchase of a condominium apartment for a total purchase price of $40,000 (including settlement costs which are capital in nature) his adjusted basis in the residence for computation of the credit is $37,500.

(4) *Basis of new principal residence.* The taxpayer's basis in his new principal residence is not in any way affected by the allowance of the credit.

(c) *Purchase*—(1) *General rule.* Except as provided in subparagraph (2) of this paragraph, the term "purchase" means any acquisition of property.

(2) *Exceptions.* (i) An acquisition does not qualify as a purchase for the purpose of this paragraph if the property is acquired from a person whose relationship to the person acquiring it would result in the disallowance of losses under section 267 or 707(b). Such persons include—

(A) The purchaser's spouse, ancestors and lineal descendants,

(B) Related corporations as provided under section 267(b)(2),

(C) Related trusts as provided under section 267(b), (4), (5), (6), and (7),

(D) Related charitable organizations as provided under section 267(b)(9), and

(E) Related partnerships as provided under section 707(b)(1).

For purposes of this subdivision the constructive ownership rules of section 267(c) shall apply except that paragraph (4) of section 267(c) shall be treated as providing that the family of an individual shall include only his spouse, ancestors, and lineal descendants.

(ii) An acquisition does not qualify as a purchase for the purpose of this paragraph if the basis of the property in the hands of the person acquiring such property is determined—

(A) In whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired (*e.g.*, a gift under section 1015), or

(B) Under section 1014(a) (relating to property acquired from a decedent).

(d) *Self-construction.* The term "self-construction" means the construction of a residence (other than a factory-made home) to the taxpayer's specifications on land already owned or leased by the taxpayer at the time of commencement of construction. Thus, where a taxpayer purchases land and either builds a residence himself or hires an architect and a contractor to build a residence on that land, the taxpayer has "self-constructed" the residence.

(e) *Factory-made home.* The term "factory-made homes" includes mobile homes, houseboats and prefabricated and modular homes.

(f) *Lowest offer.* The term "lowest offer" means the lowest price at which the residence was offered for sale after February 28, 1975.

[T.D. 7391, 40 FR 55855, Dec. 2, 1975]

EDITORIAL NOTE: The test of §§ 1.44C-1—1.44C-6 added at 45 FR 57715, August 29, 1980 appears following § 1.44A-4.

§ 1.44A-1 Expenses for household and dependent care services necessary for gainful employment.

(a) *In general.* (1) This section applies only for expenses incurred in taxable years beginning after December 31, 1975. For deductibility of expenses incurred in taxable years beginning before January 1, 1972, see § 1.214-1. For deductibility of expenses incurred in taxable years beginning after December 31, 1971, and before January 1, 1976, see §§ 1.214A-1 through 1.214A-5.

(2) Section 44A allows a credit against the tax imposed by chapter 1 of the Code to an individual who maintains a household (within the meaning of paragraph (d) of this section) which includes as a member one or more qualifying individuals (as defined in paragraph (b) of this section). The amount of the credit is equal to 20 percent of the employment-related expenses (as defined in paragraph (c) of this section) paid by the individual during the taxable year (but subject to the limits prescribed in § 1.44A-2(a)). However, the credit cannot exceed the tax imposed by chapter 1, reduced by the sum of the allowable credits enumerated in section 44A(b).

(3) Generally, the credit for employment-related expenses is allowable, regardless of the taxpayer's method of accounting, only for expenses which are actually paid during the taxable year and which are incurred during the taxable year or were incurred during a prior taxable year beginning after December 31, 1975. If the expenses are incurred but not paid during the taxable year, no credit may be taken for that year on account of those expenses. Thus, if an expense is incurred in the last month of a taxable year but not paid until the following taxable year, a credit for the expense is not allowed for the earlier taxable year but is allowed for the following taxable year. However, if an expense is incurred in a taxable year beginning before January 1, 1976, and paid in a later taxable year, no credit is allowed with respect to the expense under section 44A. Section 214 and the regulations thereunder are applicable in determining whether a deduction for the expense is allowed in the year of payment.

(4) Since an expense cannot be an employment-related expense until the services for which the expense was incurred are performed (see paragraph (c) of this section), prepaid expenses may be claimed only in the taxable year in which the services are performed.

(5) The requirements of section 44A, this section and §§ 1.44A-2 through 1.44A-4 are applied to expenses as of the time they are incurred regardless of when they are paid.

(6) For special rules relating to employment-related expenses which also qualify as medical expenses deductible under section 213, see § 1.44A-4(b).

(7) For substantiation of the credit, see paragraph (e) of this section.

(b) *Qualifying individual*—(1) *In general.* A person is considered to be a qualifying individual if he or she is—

(i) The taxpayer's dependent who is under the age of 15 and is an individual for whom the taxpayer is entitled to a deduction for a personal exemption under section 151(e);

(ii) The taxpayer's dependent (not described in subdivision (i)) who is physically or mentally incapable of self-care; or

(iii) The taxpayer's spouse who is physically or mentally incapable of self-care.

The term "dependent," as used in this paragraph (b)(1), includes any individual who is a dependent within the meaning of section 152. However, see paragraph (b)(2) of this section for special rules for determining which parent may treat a child as a qualifying individual where the parents are divorced, legally separated, or separated under a written separation agreement.

(2) *Special dependency test in case of divorced or separated parents.* A child (as defined in section 151(e)(3)) who—

(i) Is under age 15 or is physically or mentally incapable of self-care,

(ii) Receives over half of his or her support during the calendar year from his or her parents who are divorced or legally separated under a decree of divorce or separate maintenance or who are separated under a written separation agreement, and

(iii) Is in the custody of one or both of his or her parents for more than one-half of the calendar year.

is treated for any taxable year beginning in the calendar year as a qualifying individual (described in subdivision (i) or (ii), as the case may be, of paragraph (b)(1) of this section) of that parent who has custody for a longer period during the calendar year than the other parent. Accordingly, a child may be treated as a qualifying individual of a parent even though the parent is not entitled to a dependency exemption for the child. The child cannot be treated as a qualifying individual with respect to more than one parent.

(3) *Qualification on a daily basis.* The status of a person as a qualifying individual is determined on a daily basis. Thus, if a dependent or spouse of a taxpayer ceases to be a qualifying individual on September 16, the dependent or spouse is treated as a qualifying individual through September 15 only.

(4) *Physical or mental incapacity.* An individual is considered to be physically or mentally incapable of self-care if as a result of a physical or mental defect the individual is incapable of caring for his or her hygienical or nutritional needs, or requires full-time attention of another person for his or her own safety or the safety of others. The fact that an individual, by reason of a physical or mental defect, is unable to engage in any substantial gainful activity, or is unable to perform the normal household functions of a homemaker or to care for minor children, does not of itself establish that the individual is physically or mentally incapable of self-care. An individual who is physically handicapped or is mentally defective, and for such reason requires constant attention of another person, is considered to be physically or mentally incapable of self-care.

(c) *Employment-related expenses*—(1)—*Gainful employment*—(i) *In general.* Expenses are considered to be employment-related expenses only if they are incurred to enable the taxpayer to be gainfully employed and are paid for household services or for the care of one or more qualifying individuals. The expenses must be incurred while the taxpayer is gainfully employed or is in active search of gainful employment. The employment may consist of service either within or without the home of the taxpayer and may include self-employment. An expense is not considered to be employment-related merely because it is incurred while the taxpayer is gainfully employed. The purpose of the expense must be to enable the taxpayer to be gainfully employed. Volunteer work for a nominal salary does not constitute gainful employment. Whether the purpose of an expense is to enable the taxpayer to be gainfully employed depends upon the facts and circumstances of the particular case. Any tax required to be paid by the taxpayer under section 3111 (relating to the Federal Insurance Contributions Act) and 3301 (relating to the Federal Unemployment Tax Act), or under similar State payroll taxes, in respect of any wages which otherwise constitute employment-related expenses is considered to be an employment-related expense.

(ii) *Determination of period of employment on a daily basis.* An allocation of expenses is required on a daily basis when the expenses cover any period during part of which the taxpayer is gainfully employed or is in active search of gainful employment and during the other part of which there is no employment or active search for gainful employment. Thus, for example, if a taxpayer incurs during each month of the taxable year $60 of expenses which would be employment-related if he or she were gainfully employed all year, and the taxpayer is gainfully employed, or in active search of gainful employment, for only 2 months and 10 days during such year, the amount of employment-related expenses is limited to $140.

(2) *Household services.* Expenses are considered to be paid for household services if they are paid for the performance in and about the taxpayer's home of ordinary and usual services necessary to the maintenance of the household. However, expenses are not considered as paid for household services unless the expenses are attributable in part to the care of the qualify-

ing individual. Thus, amounts paid for the services of a domestic maid or cook are considered to be expenses paid for household services if a part of those services is provided to the qualifying individual. Amounts paid for the services of an individual who is employed as a chauffeur, bartender, or gardener, however, are not considered to be expenses paid for household services.

(3) *Care of qualifing individual*—(i) *In general.* The primary purpose of expenses for the care of a qualifying individual must be to assure that individual's well-being and protection. Not all benefits bestowed upon a qualifying individual are considered as provided for the individual's care. Accordingly, amounts paid to provide food, clothing, or education are not expenses paid for the care of a qualifying individual. However, where the manner of providing care is such that the expense which is incurred includes expenses for other benefits which are incident to and inseparably a part of the care, the full amount of the expense is considered to be incurred for care. Thus, for example, the full amount paid to a nursery school in which a qualifying child is enrolled is considered as being for the care of the child, even though the school also furnishes lunch and educational services. Educational expenses incurred for a child in the first or higher grade level are not expenses incurred for the care of a qualifying individual. Expenses incurred for transportation of a qualifying individual described in paragraph (b)(1)(i) of this section between the taxpayer's household and a place outside the taxpayer's household where services for the care of the qualifying individual are provided are not incurred for the care of a qualifying individual.

(ii) *Manner of providing care.* The manner of providing the care need not be the least expensive alternative available to the taxpayer. For example, the taxpayer's mother may reside at the taxpayer's home and be available to provide adequate care at no cost for the taxpayer's wife who is physically or mentally incapable of caring for herself. Nevertheless, the expenses incurred in providing a nurse for the wife may be an expense for the care of the wife. See paragraph (c)(1)(i) of this section with respect to the requirement that the expense must be for the purpose of permitting the taxpayer to be gainfully employed.

(4) *Services outside the taxpayer's household.* The credit is allowed under section 44A with respect to employment-related expenses incurred for services performed outside the household of the taxpayer only if the expenses are incurred for the care of one or more qualifying individuals of the taxpayer who are under the age of 15. Otherwise, the credit is only allowed with respect to employment-related expenses incurred for services performed in the household of the taxpayer. Thus for example, if a taxpayer places his or her invalid father in a nursing home, the taxpayer is not entitled to a credit with respect to employment-related expenses incurred for the father's care provided by the nursing home. If, however, the father remains in the taxpayer's household, the taxpayer is allowed a credit with respect to employment-related expenses attributable to the care for the father.

(5) *Allocation of expenses.* Where a portion of an expense is for household services or for the care of a qualifying individual and a portion of such expense is for other purposes, a reasonable allocation must be made and only the portion of the expense paid which is attributable to such household services or care is considered to be an employment-related expense. No allocation is required to be made, however, if the portion of expense for the other purpose is minimal or insignificant. An allocation must be made, for example, if a servant performs household duties, cares for the qualifying children of the taxpayer, and also performs social services for the taxpayer (for which a deduction is not allowable) or clerical services in the office of the taxpayer outside the home (for which a deduction may be allowable under section 162). Employment-related expenses include household service expenses which are provided in conjunction with the care of a qualifying individual. Thus, if an expense is in part attributable to the care of a quali-

fying individual and in part to household services, no allocation is required.

(6) *Illustrations.* The application of this paragraph (c) may be illustrated by the following examples:

Example (1). The taxpayer lives with her mother who is physically incapable of caring for herself. In order to be gainfully employed the taxpayer hires a practical nurse whose sole duty consists of providing for the care of the mother in the home while the taxpayer is at work. All amounts spent for the services of the nurse are employment-related expenses.

Example (2). The taxpayer has a dependent child 10 years of age who has been attending public school. The taxpayer, who has been working part time, is offered a position involving full-time employment which she can accept only if the child is placed in a boarding school. The taxpayer accepts the position and the child is sent to a boarding school. The expenses paid to the school must be allocated between that part of the expenses which represents care for the child and that part which represents tuition for education. The part of the expense representing care of the child is incurred for the purpose of permitting the taxpayer to be gainfully employed.

Example (3). The taxpayer, in order to be gainfully employed, employs a full-time housekeeper who cares for the taxpayer's two children, aged 9 and 15 years, respectively, performs regular household services of cleaning and cooking, and chauffeurs the taxpayer to and from his place of employment. The chauffeuring service never requires more than 30 minutes out of the total period of employment each day. No allocation is required for purposes of determining the portion of the expense attributable to the chauffeuring (not a household service expense) since it is *de minimis.* Further, no allocation is required for the purpose of determining the portion of the expense attributable to the care of the 15-year-old child (not a qualifying individual) since the household expense is in part attributable to the care of the 9-year-old child, who is a qualifying individual. Accordingly, the entire expense of employing the housekeeper is an employment-related expense. However, the total amount of employment-related expenses taken into account would be limited to the amount allowable for one qualifying individual.

(d) *Maintenance of a household*—(1) *In general.* An individual is considered to have maintained a household for the taxable year (or lesser period) only if the individual (and his or her spouse if the individual is married) have furnished over one-half of the cost incurred for such taxable year (or lesser period) in maintaining the household. The household must actually constitute for the taxable year the principal place of abode of the taxpayer and the qualifying individual or individuals described in paragraph (b) of this section. It is not sufficient that the taxpayer maintain the household without being its occupant. A physical change in the location of the home does not, however, prevent the home from constituting the principal place of abode of the taxpayer and a qualifying individual. The fact that an individual is born or dies during the taxable year does not prevent a home from constituting his or her principal place of abode for such year. An individual is not considered to have terminated a household as his or her principal place of abode merely by reason of temporary absences therefrom by reason of illness, education, business, vacation, military service, or a custody agreement.

(2) *Two or more families.* Solely for purposes of section 44A and this section, if two or more families occupy living quarters in common, each of the families is treated as constituting a separate household, and the taxpayer who provides more than one-half of the costs of maintaining such a separate household is treated as maintaining that household. Thus, for example, if two unrelated taxpayers each with children occupy living quarters in common and each taxpayer pays more than one-half of the household costs incurred by each respective family, each taxpayer will be treated as maintaining a separate household.

(3) *Costs of maintaining a household.* The costs of maintaining a household are the expenses incurred for the mutual benefit of the occupants thereof by reason of its operation as the principal place of abode of the occupants. The expenses of maintaining a household include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises. These expenses do not include the cost of clothing, education, medical treatment, vacations, life insurance, or transportation or payments on mortgage principal or for

the purchase, permanent improvement, betterment, or replacement of property. Further, the costs of maintaining a household do not include the value of services performed in the household by a qualifying individual described in paragraph (b) of this section. An expense incurred by a taxpayer which is paid or reimbursed by another is not considered as a cost of maintaining a household.

(4) *Monthly proration of annual costs.* In determining the cost incurred for a period of less than a taxable year in maintaining a household, the cost incurred during the entire taxable year must be prorated on the basis of the number of calendar months within such lesser period. For this purpose a period of less than a calendar month will be treated as a calendar month. Thus, for example, if the cost of maintaining a household for a taxable year is $6,600, and the period in respect of which a determination is being made under section 44A is from June 20 to December 31, the taxpayer must furnish more than $1,925 ([$6,600 × 7/12] × 50 percent) in maintaining the household from June 1 to December 31.

(e) *Substantiation.* A taxpayer claiming a credit under paragraph (a) of this section for employment-related expenses must substantiate by adequate records or other sufficient evidence any credit taken under this section. For example, if requested, the taxpayer must furnish information as to the nature and period of the physical or mental incapacity of any dependent or spouse in respect of whom a credit is claimed, including necessary information from the attending physician as to the nature of the physical or mental incapacity.

[T.D. 7643, 44 FR 50332, Aug. 28, 1979]

§ 1.44A-2 Limitations on amount creditable.

(a) *Annual dollar limit on amount creditable.* The amount of the employment-related expenses incurred during any taxable year which may be taken into account under § 1.44A-1(a) cannot exceed—

(1) $2,000 if there is one qualifying individual with respect to the taxpayer at any time during the taxable year, or

(2) $4,000 if there are two or more qualifying individuals with respect to the taxpayer at any one time during the taxable year.

For example, a calendar year taxpayer whose only qualifying individual reaches age 15 on April 1, 1976, is subject for 1976 to the entire annual dollar limit of $2,000, without proration of the $2,000 limit. However, only expenses incurred prior to the child's 15th birthday may be employment-related expenses.

(b) *Earned income limitation*—(1) *In general.* The amount of employment-related expenses incurred during any taxable year which may be taken into account under § 1.44A-1(a) cannot exceed—

(i) For an individual not married at the close of the year, the individual's earned income for the year, or

(ii) For an individual married at the close of the year, the lesser of the individual's earned income or the earned income of his or her spouse for the year.

For purposes of this paragraph (b)(1), the earned income of only the spouse to whom the taxpayer is married at the close of the year is taken into account (and not the earned income of another spouse who died or was divorced from the taxpayer during the year). Further, the spouse's earned income for the entire year is taken into account, even though the taxpayer and his or her spouse were married for only a part of the year. For purposes of this paragraph (b), certain married individuals legally separated or living apart are treated as not married (see § 1.44A-3 (b) and (c), respectively).

(2) *Earned income.* For purposes of this section, earned income means—

(i) Wages, salaries, tips, other employee compensation, and

(ii) Net earnings from self-employment (within the meaning of section 1402(a) and the regulations thereunder).

For taxable years beginning before January 1, 1979, earned income includes only amounts described in subdivision (i) or (ii) of this paragraph

(b)(2) which are includible in the eligible individual's gross income for the taxable year of the individual in which the credit is claimed. For all taxable years, however, earned income is computed without regard to any community property laws which may otherwise be applicable. Earned income is reduced by any net loss in earnings from self-employment. Earned income does not include amounts received as a pension or an annuity or an amount to which section 871(a) and the regulations thereunder apply (relating to income of nonresident alien individuals not connected with United States business).

(3) *Special rule for spouse who is a student or incapable of self-care.* (i) For purposes of this section, a spouse is deemed, for each month during which the spouse is a full-time student or is a qualifying individual described in § 1.44A-1(b)(1)(iii), to be gainfully employed and to have earned income of not less than—

(A) $166, if there is one qualifying individual with respect to the taxpayer at any time during the taxable year, or

(B) $333, if there are two or more qualifying individuals with respect to the taxpayer at any one time during the taxable year.

However, in the case of any husband and wife, this subparagraph shall apply with respect to only one spouse for any one month.

(ii) A "full-time student" is an individual who is enrolled at and attends and educational institution during each of 5 calendar months of the taxable year of the taxpayer for the number of course hours which is considered to be a full-time course of study. The enrollment for 5 calendar months need not be consecutive. School attendance exclusively at night does not constitute a full-time course of study. However, a full-time course of study may include some attendance at night.

(iii) For the definition of "educational institution", see § 1.151-3(c).

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). During the taxable year, A, a married taxpayer, incurs and pays employment-related expenses of $4,000 for the care of a qualifying individual. A's earned income for the taxable year is $20,000 and his wife's earned income is $1,500. Under these circumstances, the amount of employment-related expenses for the year which may be taken into account under § 1.44A-1(a) is $1,500, determined as follows:

Employment-related expenses incurred during taxable year ($40,000, but limited to $2,000 by paragraph (a)(1) of this section)	$2,000
Application of paragraph (b)(1)(ii) of this section (employment-related expenses, may not exceed wife's earned income of $1,500)	1,500
Employment-related expenses taken into account	1,500

Example (2). Assume the same facts as in example (1) except that A's wife is a full-time student for nine months of the taxable year and earns no income for the year. Under these circumstances, the amount of employment-related expenses for the year which may be taken into account under § 1.44A-1(a) is $1,494, determined as follows:

Employment-related expenses incurred during taxable year ($4,000, but limited to $2,000 by paragraph (a)(1) of this section)	$2,000
Application of paragraph (b)(3) of this section [employment-related expenses may not exceed wife's earned income of $1,494 ($166 x 9)]	1,494
Employment-related expenses taken into account	1,494

[T.D. 7643, 44 FR 50334, Aug. 28, 1979]

§ 1.44A-3 Special rules applicable to married individuals.

(a) *Joint return requirement.* This section applies only if the taxpayer is married at the close of a taxable year in which employment-related expenses are paid. In such a case the credit provided by section 44A with respect to employment-related expenses is allowed only if for the taxable year the taxpayer and his or her spouse file a joint return. If either spouse dies during the taxable year and a joint return may be made for the year under section 6013(a)(2) for the survivor and the deceased spouse, the credit is allowed for the year only if a joint return is made. If, however, the surviving spouse remarries before the end of the taxable year in which his or her first spouse dies, a credit is allowed on the separate return which is made for the decedent spouse. For purposes of this section, certain married individuals legally separated or living apart are treated as not married,

as provided in paragraphs (b) and (c), respectively, of this section.

(b) *Marital status.* For purposes of section 44A, an individual legally separated from his or her spouse under a decree of divorce or of separate maintenance is not considered as married.

(c) *Certain married individuals living apart.* For purposes of section 44A, an individual who is married within the meaning of section 143(a) is treated as not married for the entire taxable year, if the individual—

(1) Files a separate return for the year,

(2) Maintains as his or her home a household which constitutes for more than one-half of the taxable year the principal place of abode of a qualifying individual, and

(3) Furnishes over one-half of the cost of maintaining the household for the year,

and if the individual's spouse is not a member of the household at any time during the last 6 months of the year. Thus for example, an individual who is married during the taxable year, but is treated as not married by reason of this paragraph, may determine the earned income limitation upon the amount of employment-related expenses without taking into account the earned income of his or her spouse under § 1.44A-2(b).

[T.D. 7643, 44 FR 50335, Aug. 28, 1979]

§ 1.44A-4 Other special rules relating to employment-related expenses.

(a) *Payments to related individuals—(1) Taxable years beginning after December 31, 1978.* For taxable years beginning after December 31, 1978, a credit is not allowed under section 44A with respect to the amount of any employment-related expenses paid by the taxpayer to an individual—

(i) With respect to whom for the taxable year a deduction under section 151(e) (relating to deduction for personal exemptions for dependents) is allowable either to the taxpayer or his or her spouse, or

(ii) Who is a child of the taxpayer (within the meaning of section 151(e)(3)) who is under age 19 at the close of the taxable year.

For purposes of this paragraph (a)(1), the term "taxable year" means the taxable year of the taxpayer in which the service is performed. (1943)

(2) *Taxable years beginning before January 1, 1979.* For taxable years beginning before January 1, 1979, except as otherwise provided in paragraph (a)(3) of this section, a credit is not allowed under section 44A with respect to the amount of any employment-related expenses paid by the taxpayer to an individual who bears to the taxpayer any relationship described in section 152(a) (1) through (8). These relationships are those of a son or daughter or descendant thereof; a stepson or stepdaughter; a brother, a sister, stepbrother, or stepsister; a father or mother or an ancestor, of either; a stepfather or stepmother; a nephew or niece; an uncle or aunt; or a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law. In addition, no credit is allowed with respect to the amount of any employment-related expenses paid by the taxpayer to an individual who qualifies as a dependent of the taxpayer for the taxable year within the meaning of section 152(a)(9), which relates to an individual (other than the taxpayer's spouse) whose principal place of abode for the taxable year is the home of the taxpayer and who is a member of the taxpayer's household.

(3) *Exception for payments to certain related individuals.* For taxable years beginning before January 1, 1979, a credit is allowed for the amount of any employment-related expenses paid by the taxpayer to an individual provided that neither the taxpayer nor his or her spouse is entitled to a deduction under section 151(e) (relating to deduction for personal exemptions for dependents) with respect to such individual for the taxable year in which the service is performed; and the service with respect to which the amount is paid constitutes employment within the meaning of section 3121(b). The following services performed for a taxpayer by a relative who is an employee of the taxpayer may qualify as employment within the meaning of section 3121(b):

(i) Services performed by the taxpayer's child age 21 or over.

(ii) Domestic services in the taxpayer's home performed by the taxpayer's parent if—

(A) The taxpayer has living in his or her home a child (as defined in section 151(e)(3)) who is under age 18 or who has a physical or mental condition requiring the personal care of an adult during at least 4 continuous weeks in the calendar quarter, and

(B) The taxpayer is a widow or widower or is divorced, or has a spouse living in the home who, because of a physical or mental condition, is incapable of caring for his or her child during at least 4 continuous weeks in the calendar quarter in which services are rendered.

(iii) Services of all relatives other than a child, spouse, or parent of the taxpayer.

For taxable years beginning before January 1, 1979, a credit is not allowed under section 44A with respect to employment-related expenses paid by the taxpayer to a relative for services which do not constitute employment under section 3121(b). Services performed by a relative do not constitute employment if they relate to the relative's trade or business the income from which is includible in computing the relative's net earnings for purposes of the self-employment tax under section 1401.

(4) *Payments to entities or partnerships.* If the services are performed by an entity or partnership, paragraph (a) (1) and (2) of this section is normally not applicable. If, however, the entity or partnership is established or maintained primarily to avoid the application of paragraph (a) (1) or (2) in order to permit the taxpayer to obtain the credit with respect to employment-related expenses, for purposes of this paragraph (a), the payments of employment-related expenses shall be treated as made directly to each owner of the entity or partner in proportion to his or her share of the entity or partnership. A factor to consider for purposes of determining whether an entity or partnership is so established or maintained is whether the entity or partnership is set up solely to care for the taxpayer's qualifying individual and to provide household services to the taxpayer.

(5) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). For A's taxable year ending December 31, 1978, A, a divorced taxpayer, pays $5,000 of employment-related expenses to his mother for the care of his child age 5. A's mother cares for the child in her home. The services performed by A's mother do not constitute employment under section 3121(b). Accordingly, A is not allowed a credit with respect to the amounts paid to the mother for the care of his child.

Example (2). Assume the same facts as in example (1) except that A's taxable year under consideration begins after December 31, 1978. A is not entitled to a deduction under section 151(e) for his mother. Accordingly, A is allowed a credit with respect to the amounts paid to the mother for the care of his child even though the services performed by A's mother do not constitute employment under section 3121(b).

Example (3). For B's taxable year ending December 31, 1978, B, a divorced taxpayer, pays $6,000 of employment-related expenses to his sister (who is not a dependent of the taxpayer) for the care of his child. The services performed by B's sister in the care of his child constitute a trade or business the income from which is includible in computing net earnings for purposes of the self-employment tax under section 1401. Accordingly, B is not allowed a credit with respect to the amounts paid to the sister for the care of his child.

Example (4). Assume the same facts as in example (3) except that B's taxable year under consideration begins after December 31, 1978. B is allowed a credit with respect to the amounts paid to the sister for the care of his child, even though the services performed by B's sister do not constitute employment under section 3121(b).

(b) *Expenses qualifying as medical expenses.* An expense which may constitute an amount otherwise deductible under section 213, relating to medical, etc., expenses, may also constitute an expense with respect to which a credit is allowable under section 44A. In such a case, that part of the amount with respect to which a credit is allowed under section 44A will not be considered as an expense for purposes of determining the amount deductible under section 213. On the other hand, where an amount is treated as a medical expense under section 213 for purposes of determining the amount deductible under that section, it may not be treated as an employ-

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ment-related expense for purposes of section 44A. The application of this paragraph may be illustrated by the following examples:

Example (1). A taxpayer pays $5,000 of employment-related expenses during the taxable year for the care of his child when the child is physically incapable of self-care. These expenses are incurred for services performed in the taxpayer's household and are of a nature which qualify as medical expenses under section 213. The taxpayer's adjusted gross income for the taxable year is $100,000. Of the total expenses, the taxpayer may take $2,000 into account under section 44A; the balance of the expenses, or $3,000, may be treated as medical expenses to which section 213 applies. However, this amount does not exceed 3 percent of the taxpayer's adjusted gross income for the taxable year and is thus not allowable as a deduction under section 213.

Example (2). Assume the same facts as in example (1). It is not proper for the taxpayer first to determine his deductible medical expenses of $2,000 ($5,000—[$100,000 · 3 percent]) under section 213 and then claim the $3,000 balance as employment-related expenses for purposes of section 44A. This is because the $3,000 balance has been treated as a medical expense in computing the amount deductible under section 213.

Example (3). A taxpayer incurs and pays $12,000 of employment-related expenses during the taxable year for the care of his child. These expenses are incurred for services performed in the taxpayer's household, and they also qualify as medical expenses under section 213. The taxpayer's adjusted gross income for the taxable year is $18,000. The taxpayer takes $2,000 of such expenses into account under section 44A. The balance, or $10,000, he treats as medical expenses for purposes of section 213. The allowable deduction under section 213 for the expenses is limited to the excess of the balance of $10,000 over $540 (3 percent of the taxpayer's adjusted gross income of $18,000), or $9,460.

[T.D. 7643, 44 FR 50335, Aug. 28, 1979]

§ 1.44C-1 Residential energy credit.

(a) *General rule.* Section 44C provides a residential energy credit against the tax imposed by Chapter 1 of the Internal Revenue Code. The credit is an amount equal to the individual's qualified energy conservation expenditures (set out in paragraph (b)) plus the individual's qualified renewable energy source expenditures (set out in paragraph (c)) for the taxable year. However, the credit is subject to the limitations described in paragraph (d) and the special rules contained in § 1.44C-3. The credit is nonrefundable (that is, the credit may not exceed an individual's tax liability for the taxable year). However, any unused credit may be carried over to succeeding years to the extent permitted under paragraph (e). Renters as well as owners of a dwelling unit may qualify for the credit. See § 1.44C-3(h) for the rules relating to the allocation of the credit in the case of joint occupants of a dwelling unit.

(b) *Qualified energy conservation expenditures.* In the case of any dwelling unit, the qualified energy conservation expenditures are 15 percent of the energy conservation expenditures made by the taxpayer with respect to the dwelling unit during the taxable year, but not in excess of $2,000 of such expenditures. See § 1.44C-2(a) for the definition of energy conservation expenditures.

(c) *Qualified renewable energy source expenditures.* In the case of any dwelling unit, the qualified renewable energy source expenditures are the renewable energy source expenditures made by the taxpayer with respect to the dwelling unit during the taxable year, but not in excess of—

(1) 30 percent of the expenditures up to $2,000, plus

(2) 20 percent of the expenditures over $2,000, but not more than $10,000.

See § 1.44C-2(b) for the definition of renewable energy source expenditures.

(d) *Limitations—(1) Minimum dollar amount.* No residential energy credit shall be allowed with respect to any return (whether joint or separate) for any taxable year if the amount of the credit otherwise allowable (determined without regard to the tax liability limitation imposed by paragraph (d)(3) of this section) is less than $10.

(2) *Prior expenditures taken into account*—(i) *In general.* For purposes of determining the credit for expenditures made during a taxable year, the taxpayer must reduce the maximum amount of allowable expenditures with respect to the dwelling until in computing qualified energy conservation expenditures (under paragraph (b)) or qualified renewable energy con-

servation expenditures (under paragraph (c)) by prior expenditures which were made by the taxpayer or by joint occupants (see § 1.44C-3(h)) with respect to the same dwelling unit, and which were taken into account in computing the credit for prior taxable years. The reduction of the maximum amount under paragraph (c) must first be made with respect to the first $2,000 of expenditures (to which a 30 percent rate applies) and then with respect to the next $8,000 of expenditures (to which a 20 percent rate applies). This reduction must be made if all or any part of the credit was allowed in or was carried over from a prior taxable year.

(ii) *Change of principal residence.* A taxpayer is eligible for the maximum credit for qualifying expenditures made with respect to a new principal residence notwithstanding the allowance of a credit for qualifying expenditures made with respect to the taxpayer's previous principal residence. Furthermore, except in certain cases involving joint occupancy (see § 1.44C-3(h)), a taxpayer is eligible for the maximum credit notwithstanding the allowance of a credit to a prior owner of the taxpayer's new principal residence.

(iii) *Example.* The rules with respect to the reduction for prior expenditures are illustrated by the following example:

Example. In 1978, A has $1,000 of energy conservation expenditures and $5,000 of renewable energy source expenditures in connection with A's principal residence. A's residential energy credit for 1978 is $1,350, made up of $150 of qualified energy conservation expenditures (15 percent of $1,000) plus $1,200 of qualified renewable energy source expenditures (30 percent of the first $2,000 plus 20 percent of the next $3,000). In 1979 A has an additional $2,000 of energy conservation expenditures and $3,000 of renewable energy source expenditures in connection with the same principal residence. A's residential energy credit for 1979 is $750, made up of $150 of qualified energy conservation expenditures (15 percent of the new maximum $1,000, which was reduced from $2,000 by $1,000 of energy conservation expenditures taken into account in 1978) plus $600 of qualified renewable energy source expenditures (20 percent of $3,000, which reflects the reduction of the maximum allowable expenditures by the $5,000 of renewable energy source expenditures taken into account in 1978). The maximum residential energy credit allowable to A with respect to the same principal residence in subsequent years in which the credit is allowable is $400 (20 percent of the new maximum of $2,000 for renewable energy source expenditures and none for energy conservation expenditures).

(3) *Tax liability limitation.* The credit allowed by this section shall not exceed the amount of the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year, reduced by the sum of the credits allowable under—

(i) Section 32 (relating to tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds),

(ii) Section 33 (relating to the taxes of foreign countries and possessions of the United States),

(iii) Section 37 (relating to retirement income),

(iv) Section 38 (relating to investment in certain depreciable property),

(v) Section 40 (relating to expenses of work incentive programs),

(vi) Section 41 (relating to contributions to candidates for public office),

(vii) Section 42 (relating to the general tax credit),

(viii) Section 44 (relating to purchase of new personal residence),

(ix) Section 44A (relating to expenses for household and dependent care services), and

(x) Section 44B (relating to employment of certain new employees).

(e) *Carryover of unused credit.* If the credit allowable by this section exceeds the tax liability limitation imposed by section 44C(b)(5) and paragraph (d)(3) of this section, the excess credit shall be carried over to the succeeding taxable year and added to the credit allowable under this section for the succeeding taxable year. A carryover that is not used in the succeeding year because it exceeds the tax liability limitation shall be carried over to later taxable years until used, except that no excess credit may be carried over to any taxable year beginning after December 31, 1987.

[T.D. 7717, 45 FR 57715, Aug. 29, 1980]

§ 1.44C-2 Definitions.

For purposes of section 44C and regulations thereunder—

(a) *Energy conservation expenditures*—(1) *In general.* The term "energy conservation expenditure" means an expenditure made on or after April 20, 1977, and before January 1, 1986, by a taxpayer for insulation or any other energy-conserving component, or for labor costs allocable to the original installation of such insulation or other component, if all of the following conditions are satisfied:

(i) The insulation (as defined in paragraph (c)) or other energy-conserving component (as defined in paragraph (d)) is installed in or on a dwelling unit that is used as the taxpayer's principal residence when the installation is completed. See § 1.44C-3(e) for the definition of principal residence.

(ii) The dwelling unit is located in the United States (as defined in section 7701(a)(9)).

(iii) The construction of the dwelling unit was substantially completed before April 20, 1977. See § 1.44C-3(f) for the definition of the terms "construction" and "substantially completed". In the case of expenditures made with respect to the enlargement of a dwelling unit, the construction of the enlargement must have been substantially completed before April 20, 1977.

(2) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example (1). In 1978, A spent $500 for the purchase and installation of new storm windows to replace old storm windows, $100 to reinstall old storm windows, and $150 to transfer a A's house insulation which had been installed in A's garage. Only the $500 spent for new storm windows qualifies as an energy conservation expenditure. The $100 spent to reinstall storm windows and the $150 spent to transfer insulation to A's house do not qualify since the only installation costs that qualify are those for the original installation of energy conservation property the original use of which commences with the taxpayer.

Example (2). In June 1977, B purchased for B's principal residence a new house that was substantially completed before April 20, 1977. Pursuant to B's request the builder installed storm windows on May 1, 1977, the cost of this option being included in the purchase price of the house. The portion of the purchase price of the residence allocable to the storm windows constitutes an energy conservation expenditure. However, no other part of the purchase price may be allocated to energy conservation property (insulation and other energy conserving components) installed before April 20, 1977. To qualify as an energy conservation expenditure, an expenditure must be made (*i.e.*, installation of the energy conservation property must be completed) on or after April 20, 1977.

(b) *Renewable energy source expenditures.* The term "renewable energy source expenditures" means an expenditure made on or after April 20, 1977, and before January 1, 1986, by a taxpayer for renewable energy source property (as defined in paragraph (e)), or for labor costs properly allocable to the on-site preparation, assembly, or original installation such property, if both of the following conditions are satisfied:

(1) The renewable energy source property is installed in connection with a dwelling unit that is used as the taxpayer's principal residence when the installation is completed. See § 1.44C-3(e).

(2) The dwelling unit is located in the United States (as defined in section 7701(a)(9)).

Eligibility as a renewable energy source expenditure does not depend on the date of construction of the dwelling unit. Thus, such an expenditure may be made in connection with either a new or an existing dwelling unit. Renewable energy source expenditures need only be made in connection with a dwelling, rather than in or on a dwelling unit. For example, a solar collector that otherwise constitutes renewable energy source property is not ineligible merely because it is installed separately from the dwelling unit. The term "renewable energy source expenditure" does not include any expenditure allocable to a swimming pool even when used as an energy storage medium or to any other energy storage medium whose primary function is other than the storage of energy. It also does not include the cost of maintenance of an installed system or the cost of leasing renewable energy source property.

(c) *Insulation.* The term "insulation" means any item that satisfies all of the following conditions:

(1) The item is specifically and primarily designed to reduce, when installed in or on a dwelling or on a water heater, the heat loss or gain of such dwelling or water heater. To qualify as insulation the item must be installed between a conditioned area and a nonconditioned area (except when installed on a water heater, water pipe, or heating/cooling duct). Thus for example, awnings do not qualify as insulation. For purposes of this section the term "conditioned area" means an area that has been heated or cooled by conventional or renewable energy source means. Insulation includes materials made of fiberglass, rock wool, cellulose, urea based foam, urethane, vermiculite, perlite, polystyrene, and extruded polystyrene foam.

(2) The original use of the item begins with the taxpayer.

(3) The item can reasonably be expected to remain in operation at least 3 years.

(4) The item meets the applicable performance and quality standards prescribed in § 1.44C-4 (if any) that are in effect at the time the taxpayer acquires the item. The term "insulation" shall not include items whose primary purpose is not insulation (e.g., whose function is primarily structural, decorative, or safety-related). For example, carpeting, drapes (including linings), shades, wood paneling, fireplace screens (including those made of glass), new or replacement walls (except for qualifying insulation therein) and exterior siding do not qualify although they may have been designed in part to have an insulating effect.

(d) *Other energy-conserving components.* The term "other energy-conserving component" means any item (other than insulation) that satisfies all of the following conditions:

(1) The original use of the item begins with the taxpayer.

(2) The item can reasonably be expected to remain in operation for at least 3 years.

(3) The item meets the applicable performance and quality standards prescribed in § 1.44C-4 (if any) that are in effect at the time of the taxpayer's acquisition of the item.

(4) The item is one of the following items:

(i) *A furnace replacement burner.* The term "furnace replacement burner" means a device (for oil and gas-fired furnaces or boilers) that is designed to achieve a reduction in the amount of fuel consumed as a result of increased combustion efficiency. The burner must replace an existing burner. It does not qualify if it is acquired as a component of, or for use in, a new furnace or boiler.

(ii) *A device for modifying flue openings.* The term "device for modifying flue openings" means an automatically operated damper that—

(A) Is designed for installation in the flue, between the barometric damper or draft hood and the chimney, of a furnace; and

(B) Conserves energy by substantially reducing the flow of conditioned air through the chimney when the furnace is not in operation. Conditioned air is air that has been heated or cooled by conventional or renewable energy source means.

(iii) *A furnace ignition system.* The term "furnace ignition system" means an electrical or mechanical device, designed for installation in a gas-fired furnace or boiler that automatically ignites the gas burner. In order to qualify, the device must replace a gas pilot light. Furthermore, it does not qualify if it is acquired as a component of, or for use in, a new furnace or boiler.

(iv) *A storm or thermal window or door.* The terms "storm or thermal window" and "storm or thermal door" include the following:

(A)(*1*) A window placed outside or inside an ordinary or prime window, creating an insulating air space.

(*2*) A window with enhanced resistance to heat flow through the glazed area by multi-glazing.

(*3*) A window that consists of glass or other glazing materials that have exceptional heat-absorbing or heat-reflecting properties. For purposes of this subdivision (iv), the term "glazing material" does not include films and

coatings applied on the surface of a window.

(B)(*1*) A second door, installed outside or inside a prime exterior door, creating an insulating air space.

(*2*) A door with enhanced resistance to heat flow through the glazed area by multi-glazing.

(*3*) A prime exterior door that has an R-value (a measurement of the ability of insulation to resist the flow of heat) of at least 2 throughout.

For purposes of this subdivision, "multi-glazing" is an arrangement in which two or more sheets of glazing material are affixed in a window or door frame to create one or more insulating air spaces. Multi-glazing can be achieved by installing a preassembled, sealed insulating glass unit or by affixing one or more additional sheets of glazing onto an existing window (or sash) or door. For purposes of this subdivision, a storm or thermal window or door does not include any film applied on or over the surface of a window or door.

(v) *Automatic energy-saving setback thermostat.* The term "automatic energy-saving setback thermostat" means a device that is designed to reduce energy consumption by regulating the demand on the heating or cooling system in which it is installed, and uses—

(A) A temperature control device for interior spaces incorporating more than one temperature control level, and

(B) A clock or other automatic mechanism for switching from one control level to another.

(vi) *Caulking and weatherstripping.* The term "caulking" means pliable materials used to fill small gaps at fixed joints on buildings to reduce the passage of air and moisture. Caulking includes, but is not limited to, materials commonly known as "sealants", "putty", and "glazing compounds". The term "weatherstripping" means narrow strips of material placed over or in movable joints of windows and doors to reduce the passage of air and moisture.

(vii) *Energy usage display meter.* The term "energy usage display meter" means a device the sole purpose of which is to display the cost (in money) of energy usage in the dwelling. It may show cost information for electricity usage, gas usage, oil usage, or any combination thereof. The device may measure energy usage of the whole dwelling, or individual appliances or systems on an instantaneous or cumulative basis.

(viii) *Components specified by the Secretary.* The Secretary (or his delegate) may, in his discretion, after consultation with the Secretary of Energy and the Secretary of Housing and Urban Development (or their delegates), and any other appropriate Federal officers, specify by regulation other energy-conserving components for addition to the list of qualified items. See § 1.44C-6 for the procedures and criteria to be used in determining whether an item will be considered for addition to the list of qualified items by the Secretary.

The term "other energy-conserving component" is limited to items in a category specifically listed in section 44C(c)(4)(A) (i) through (vii) or added by the Secretary.

(e) *Renewable energy source property*—(1) *In general.* The term "renewable energy source property" includes any solar energy property, wind energy property, geothermal energy property, or property referred to in subparagraph (2), which meets the following conditions:

(i) The original use of the property begins with the taxpayer.

(ii) The property can reasonably be expected to remain in operation for at least 5 years.

(iii) The property meets the applicable performance and quality standards prescribed in § 1.44C-4 (if any) that are in effect at the time of the taxpayer's acquisition of the property.

Renewable energy source property does not include heating and cooling systems which serve to supplement renewable energy source equipment in heating or cooling a dwelling unit, and which employ a form of energy (such as electricity, oil or gas) other than solar, wind, or geothermal energy (or other forms of renewable energy provided in subparagraph (2)). Thus, heat pumps or oil or gas furnaces, used in connection with renewable energy source property, are not eligible for

the credit. In order to be eligible for the credit for renewable energy source property, the property (as well as labor costs properly allocable to onsite preparation, assembly or installation of equipment) must be clearly identifiable. See § 1.44C-3(l) for recordkeeping rules.

(2) *Renewable energy source specified by the Secretary.* In addition to solar, wind, and geothermal energy property, renewable energy source property includes property that transmits or uses another renewable energy source that the Secretary (or his delegate) specifies by regulations, after consultation with the Secretary of Energy and the Secretary of Housing and Urban Development (or their delegates), and any other appropriate Federal officers, to be of a kind that is appropriate for the purpose of heating or cooling the dwelling or providing hot water for use within the dwelling. For purposes of this section, references to the transmission or use of energy include its collection and storage. See § 1.44C-6 for the procedures and criteria to be used in determining when another energy source will be considered for addition to the list of qualified renewable energy sources.

(f) *Solar energy property*—(1) *In general.* The term "solar energy property" means equipment and materials of a solar energy system as defined in this paragraph (and parts solely related to the functioning of such equipment) which, when installed in connection with a dwelling, transmits or uses solar energy to heat or cool the dwelling or to provide hot water for use within the dwelling. For this purpose, solar energy is energy derived directly from sunlight (solar radiation). Property which uses, as an energy source, fuel or energy which is indirectly derived from sunlight (solar radiation), such as fossil fuel or wood or heated underground water is not considered solar energy property. Materials and components of "passive solar systems" as well as "active solar systems", or a combination of both types of systems may qualify as solar energy property.

(2) *Active solar system.* An active solar system is based on the use of mechanically forced energy transfer, such as the use of fans or pumps to circulate solar generated energy, or thermal energy transfer, such as systems utilizing thermal siphon principles. Generally, this is accomplished through the use of equipment such as collectors (to absorb sunlight and create hot liquids or air), storage tanks (to store hot liquids), rockbeds (to store hot air), thermostats (to activate pumps or fans which circulate the hot liquids or air), and heat exchangers (to utilize hot liquids or air to heat air or water).

(3) *Passive solar system.* A passive solar system is based on the use of conductive, convective, or radiant energy transfer. In order to qualify as a passive solar system, a solar system used for heating purposes must contain all of the following: a solar collection area, an absorber, a storage mass, a heat distribution method, and heat regulation devices. The term "solar collection area" means an expanse of transparent or translucent material, such as glass which is positioned in such a manner that the rays of the sun directly strike an absorber. The term "absorber" means a surface, such as a floor, that is exposed to the rays of the sun admitted through the solar collection area, which converts solar radiation into heat, and then transfers the heat to a storage mass. The term "storage mass" means material, such as masonry, that receives and holds heat from the absorber and later releases the heat to the interior of the dwelling. The storage mass must be of sufficient volume, depth, and thermal energy capacity to store and deliver adequate amounts of solar heat for the relative size of the dwelling. In addition, the storage mass must be located so that it is capable of distributing the stored heat directly to the habitable areas of the dwelling through a heat distribution method. The term "heat distribution method" means the release of radiant heating from the storage mass within the habitable areas of the dwelling, or convective heating from the storage mass through airflow paths provided by openings or by ducts in the storage mass, to habitable areas of the dwelling. The term "heat regulations devices" means shading or venting mechanisms (such as awnings or insulated

drapes) to control the amount of solar heat admitted through the solar collection areas and nighttime insulation or its equivalent to control the amount of heat permitted to escape from the interior of the dwelling.

(4) *Components with dual function.* To the extent that a passive or active solar system utilizes portions of the structure of a residence, only the materials and components whose sole purpose is to transmit or use solar radiation (and labor costs associated with installing such materials and components) are included within the term "solar energy property". Accordingly, materials and components that serve a dual purpose, *e.g.*, they have a significant structural function or are structural components of the dwelling (and labor costs associated with installing such materials and components) are not included within the term "solar energy property". For example, solar collectors and roof ponds that form part of a roof (including additional structural components to support the roof), windows (including clerestories and skylights), and greenhouses do not qualify as solar energy property. In the case of a trombe wall (a south facing wall composed of a mass wall and exterior glazing), the mass wall (and labor costs associated with installing the mass wall) will not qualify. However, the exterior (non-window) glazing will qualify. Any shading, venting and heat distribution mechanisms or storage systems that do not have a dual function will also qualify.

(g) *Wind energy property.* The term "wind energy property" includes equipment (and parts solely related to the functioning of such equipment) which, when installed in connection with a dwelling, transmits or uses wind energy to produce energy in a useful form for personal residential purposes. Examples of equipment using wind energy to produce energy in a useful form are windmills, wind-driven generators, power conditioning and storage devices that use wind to generate electricity or mechanical forms of energy. Devices that use wind merely to ventilate do not qualify as wind energy property.

(h) *Geothermal energy property.* The term "geothermal energy property" includes equipment (and parts solely related to the functioning of such equipment) necessary to transmit or use energy from a geothermal deposit to heat or cool a dwelling or provide hot water for use within the dwelling. Equipment such as a pipe that serves both a geothermal function (by transmitting hot geothermal water within a dwelling) and a non-geothermal function (by transmitting hot water from a water heater within a dwelling) does not qualify as geothermal property. A geothermal deposit is a geothermal reservoir consisting of natural heat which is from an underground source and is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure), having a temperature exceeding 50 degrees Celsius as measured at the wellhead or, in the case of a natural hot spring (where no well is drilled), at the intake to the distribution system.

[T.D. 7717, 45 FR 57716, Aug. 29, 1980]

§ 1.44C-3 Special rules.

(a) *When expenditures are treated as made*—(1) *Timeliness of an expenditure for the energy credit.* In general, for the purpose of determining whether an expenditure qualifies as being timely for the residential energy credit under section 44C (*i.e.*, is made after April 19, 1977, and before January 1, 1986), the expenditure is treated as made when original installation of the item is completed. Thus, solely for that purpose, the time of payment or accrual is irrelevant.

(2) *Special rule for renewable energy source expenditures in the case of construction or reconstruction of a dwelling.* In the case of renewable energy source expenditures in connection with the construction or reconstruction of a dwelling that becomes the taxpayer's new principal residence, the expenditures are to be treated as made (for the purpose of determining the timeliness of an expenditure for the residential energy credit) when the taxpayer commences use of the dwelling as his or her principal residence following its construction or reconstruction. The term "reconstruction"

means the replacement of most of a dwelling's major structural components such as floors, walls, and ceiling. When a taxpayer reoccupies a reconstructed dwelling that was the taxpayer's principal residence prior to reconstruction, a renewable energy source expenditure is considered made when the original installation of the renewable energy source property is completed.

(3) *Taxable year in which credit is allowable.* For the purpose of determining the taxable year in which the credit for an expenditure is allowable (once it has qualified as timely under subparagraph (1) or (2)), an expenditure is treated as made on the later of (i) the date on which it qualifies as timely; or (ii) the date on which it is paid or incurred by the taxpayer.

(b) *Expenditures in 1977.* No credit under section 44C shall be allowed for any taxable year beginning before 1978. However, the amount of any credit under section 44C for the taxpayer's first taxable year beginning after December 31, 1977, shall take into account qualified energy conservation expenditures and qualified renewable energy source expenditures made during the period beginning April 20, 1977, and ending on the last day of such first taxable year.

(c) *Expenditures financed with Federal, etc., grants.* Qualified expenditures financed with Federal, State or other grants shall be taken into account for purposes of computing the residential energy credit only if such amounts are taxable as gross income under section 61 (relating to the definition of gross income) and the regulations thereunder.

(d) *Expenditures qualifying both as energy conservation expenditures and renewable source expenditures.* In the case of an expenditure which meets both the definition of an energy conservation expenditure (as defined in § 1.44C-2(a)) and a renewable energy source expenditure (as defined in § 1.44C-2(b)), the taxpayer may claim either a credit under § 1.44C-1(b) (relating to qualified energy conservation expenditures) or § 1.44C-1(c) (relating to qualified renewable energy source expenditures) but may not claim both credits with respect to the same expenditure.

(e) *Principal residence.* For purposes of section 44C, the determination of whether a dwelling unit is the taxpayer's principal residence shall be made under principles similar to those applicable to section 1034 and the regulations thereunder (relating to sale or exchange of a principal residence) except that ownership of the dwelling unit is not required. In making this determination, the period for which a dwelling is treated as a taxpayer's principal residence includes the 30-day period ending on the first day on which the dwelling unit would (but for this sentence) be treated as being used as the taxpayer's principal residence under principles similar to those applicable to section 1034. Thus, installation that are completed within that 30-day period may be eligible for the credit although, in the absence of the 30-day rule, the date of habitation of the dwelling unit by the taxpayer would mark the beginning of the taxpayer's use of the unit as a principal residence.

(f) *Construction substantially completed.* Construction of a dwelling unit is substantially completed when construction has progressed to the point where the unit could be put to use as a personal residence, even though comparatively minor items remain to be finished or performed in order to conform to the plans or specifications of the completed building. For this purpose, construction includes reconstruction as defined in paragraph (a)(2). This rule may be illustrated by the following example:

Example. On January 1, 1979, A purchases a dwelling that is to become A's prinicpal residence. The dwelling unit was originally constructed in 1950. A spends $50,000 to reconstruct the dwelling by replacing most of the dwelling's major structural components such as floors, walls, and ceilings. Included in the cost is $3,000 attributable to energy-conserving components. Reconstruction is substantially completed on April 1, 1979, and A moves into the reconstructed residence on May 1, 1979. Since construction includes reconstruction, A's reconstructed residence is not considered substantially completed before April 20, 1977. Thus, amounts spent with respect to A's reconstructed residence for energy-conserving

components do not qualify as energy conservation expenditures.

(g) *Residential use of property.* To be eligible for the residential energy credit, expenditures must be made for personal residential purposes. If at least 80 percent of the use of a component or item of property is for personal residential purposes, the entire amount of the energy conservation expenditure or the renewable energy source expenditure is taken into account in computing the credit under this section. If less than 80 percent of the use of a component or item of property is for personal residential purposes, the amount of an expenditure taken into account is the amount that bears the same ratio to the amount of the expenditure as the amount of personal residential use of the component or item bears to its total use. For purposes of this paragraph, use of a component or an item of property with respect to a swimming pool is not a use for a personal residential purpose. The rules with respect to residential use of property are illustrated by the following examples:

Example (1). In 1978 A makes an expenditure of $3,000 for the installation of storm windows of which 50 percent is on the portion of A's dwelling used as the principal family residence and 50 percent is on the portion of the dwelling used as an office. A has made no other energy conservation expenditures for the residence. The allowable energy conservation expenditure is $1,500 (50 percent of $3,000), the portion attributable to residential use. Therefore, the residential energy credit is $225 (the qualified conservation expenditure of 15 percent of $1,500).

Example (2). During 1979, B makes $10,000 of renewable energy source expenditures on solar energy property for B's principal residence. Approximately 60 percent of the use of the solar energy property will be for heating B's swimming pool; the other 40 percent will be for heating the dwelling unit. B had not previously made renewable energy source expenditures with respect to the residence. Since use for a swimming pool is not considered a residential use, less than 80 percent of the use of B's solar energy property is considered used for personal residential purposes. Therefore, only $4,000 (40 percent of $10,000), the proportionate part of B's expenditures representing personal residential use, is treated as a renewable energy source expenditure. B is allowed a $1,000 residential energy credit (30 percent of $2,000 plus 20 percent of $2,000) for 1979.

(h) *Joint occupancy*—(1) *In general.* If two or more individuals jointly occupied and used a dwelling unit as their principal residence during any portion of a calendar year—

(i) The amount of the credit allowable under section 44C by reason of energy conservation expenditures or by reason of renewable energy source expenditures shall be determined by treating all of the joint occupants as one taxpayer whose taxable year is such calendar year; and

(ii) The credit under section 44C allowable to each joint occupant for the taxable year with which or in which such calendar year ends shall be an amount which bears the same ratio to the amount determined under paragraph (h)(1)(i) of this section as the amount of energy conservation expenditures or renewable energy source expenditures made by that occupant bears to the total amount of each type of such expenditures made by all joint occupants during such calendar year.

The provisions of this subparagraph may be illustrated by the following example:

Example. A, a calendar year taxpayer, and B, a June 1 fiscal year taxpayer, make energy conservation exenditures of $2,000 (A making expenditures of $500 and B making expenditures of $1,500) on their principal and jointly occupied residence in 1978. A and B have not previously make energy conservation expenditures with respect to this residence. Of the $300 credit (15 percent of $2,000), $75 will be allocated to A ($500/$2,000 · $300) and $225 to B ($1,500/$2,000 · 300). A will claim the allocable share of the credit on A's 1978 tax return and B will claim the allocable share of the credit on B's tax return for the fiscal year ending May 31, 1979.

(2) *Minimum credit.* The fact that one joint occupant may be unable to claim all or part of the credit under section 44C because of insufficient tax liability or because that occupant's allowable credit does not exceed the $10 minimum credit (as set forth in paragraph (d)(1) of § 1.44C-1) shall have no effect upon the computation of the amount of the allowable credits for the other joint occupants.

(3) *Prior expenditures.* Because joint occupants are treated as one taxpayer for purposes of determining the residential energy credit, the maximum amount of energy conservation expenditures or renewable energy source expenditures must be reduced by the total amount of such expenditures made in connection with the dwelling unit during prior calendar years in which any one of the residents of the unit during the current calendar year was a resident (whether made by the current resident or by an individual previously occupying the dwelling with the current resident). However, the preceding sentence shall not apply to prior expenditures no part of which was taken into account in computing the credits under section 44C for such years. Prior years' expenditures are not to be allocated among joint occupants to take into account the specific expenditures of each of the occupants in prior years.

(4) The rules of this paragraph may be illustrated by the following examples:

Example (1). Assume A and B have together made prior years' energy conservation expenditures of $1,600 (A having made $1,200 of expenditures and B having made $400) on their principal and jointly occupied residence. In the current year, each makes energy conservation expenditures of $300 with respect to the same residence. The maximum qualified expenditure with respect to the residence is reduced by the $1,600 of prior expenditures made by A and B. Therefore, only $400 of the $600 current expenditures are eligible as energy conservation expenditures. The resulting residential energy credit is $60 (15 percent of $400) of which $30 apiece will be allocated to A and B ($300/$600 × $60). The fact that A had previously computed the credit in prior years with respect to $1,200 of the total $1,600 of expenditures is irrelevant to the apportionment of the credit in the current year.

Example (2). Spouses C and D make $10,000 of renewable energy source expenditures with respect to their principal residence, half of which is paid by each spouse. No prior renewable energy source expenditures have been taken into account with respect to that residence by either C or D. C and D file separate returns for the calendar year. Under the joint occupancy rule, the maximum allowable renewable energy source credit with respect to C and D's principal residence is $2,200 (30 percent of the first $2,000, and 20 percent of the next $8,000 of expenditures). Half of this amount or $1,100, will be allowed to each spouse. If either spouse makes renewable energy source expenditures with respect to the same principal residence in future years, none of those expenditures would be qualified renewable energy source expenditures for which a credit can be claimed. That is, not more than $2,200 may be taken in the aggregate by C and D as a renewable energy source credit with respect to their principal residence.

Example (3). In 1978, E and F make energy conservation expenditures of $1,500 on their principal and jointly occupied residence. In 1979, E moves away and G becomes the other joint occupant of the residence. F and G make energy conservation expenditures of $1,000 in 1979. In 1980 F moves away and H moves in with G. G and H make energy conservation expenditures of $500. The maximum qualified expenditure made by F and G with respect to the residence is reduced by the $1,500 of prior expenditures made in 1978 by E and F. The maximum qualified expenditures made by G and H with respect to the residence is reduced only by the expenditures in prior years in connection with the residence during which either G or H was a joint occupant. Accordingly, the maximum qualified expenditures made by G and H with respect to the residence is reduced only by the $1,000 of prior expenditures made in 1979 by F and G.

(l) *Condominiums and cooperative housing corporations.* An individual who is a tenant stockholder in a cooperative housing corporation (as defined in section 216) or who is a member of a condominium management association with respect to a condominium which he or she owns shall be treated as having made a proportionate share of the energy conservation expenditures or renewable energy source expenditures of such corporation or association. The cooperative stockholder's allocable share of the expenditures is to be the same as his or her proportionate share of the cooperative's total outstanding stock (including any stock held by the corporation). However, in the case where only certain cooperative stockholders are assessed for the expenditures made by the cooperative housing corporation, only those cooperative stockholders that are assessed shall be treated as having made a share of the expenditures of such corporation. In such case, the cooperative stockholder's

share of the expenditures is the amount that the stockholder is assessed. The allocable share of a condominium management association member's energy conservation of renewable energy source expenditures is the amount that the member is assessed (or would be assessed in the case where expenditures are from general funds) by the association as a result of such expenditures. The residential energy credit for a qualified expenditure is allowable for the year in which the association or corporation has completed original installation of the item (or has paid or incurred the expenditure, if later). For purposes of this paragraph, the term "condominium management association" means an organization meeting the requirements of section 528(c)(1) of the Code (other than subparagraph (E) of that section), with respect to a condominium project substantially all the units of which are used as residences.

(j) *Joint ownership of renewable energy source property*—(1) *In general.* Renewable energy source property includes property which is jointly owned by the taxpayer and another person (or persons). For example, the fact that a windmill, solar collector, or geothermal well and distribution system is owned by two or more individuals does not by itself preclude qualification as renewable energy property.

(2) *Example.* The application of this subparagraph may be illustrated by the following example:

Example. A, B, and C each has a separate principal residence. They agree to finance jointly the construction of a solar collector, each providing one-third of the costs and taking one-third of the output of the collector. Each will separately pay for the costs of connecting the solar collector with his or her principal residence. Provided the solar collector and connection equipment otherwise qualify as renewable energy source property, A, B, and C will each be considered to have made renewable energy source expenditures equal to one-third of the cost of the collector plus his or her separate connection costs. Such expenditures will be subject to the limitations and other rules separately applicable to A, B, and C with respect to each principal residence, such as those with respect to the $10 minimum (§ 1.44C-1(d)(1)), prior expenditures (§ 1.44C-1(d)(2)), residential use (paragraph (g) of this section), and joint occupancy (paragraph (h) of this section).

(k) *Basic adjustments.* If a credit is allowed under section 44C for any expenditure with respect to any property, the increase in the basis of that property which would (but for this paragraph) result from such expenditure shall be reduced by the amount of the credit allowed.

(l) *Recordkeeping*—(1) *In general.* No residential energy credit is allowable unless the taxpayer maintains the records described in paragraph (l)(2) of this section. The records shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(2) *Records.* The taxpayer must maintain records that clearly identify the energy-conserving components and renewable energy source property with respect to which a residential energy credit is claimed, and substantiate their cost to the taxpayer, any labor costs properly allocable to them paid for by the taxpayer, and the method used for allocating such labor costs.

[T.D. 7717, 45 FR 57719, Aug. 29, 1980]

§ 1.44C-4 Performance and quality standards. [Reserved]

§ 1.44C-5 Certification procedures.

(a) *Certification that an item meets the definition of an energy-conserving component or renewable energy source property.* Upon the request of a manufacturer of an item pursuant to paragraph (b) of this section which is supported by proof that the item is entitled to be certified, the Assistant Commissioner (Technical) shall certify (or shall notify the manufacturer that the request is denied) that:

(1) The item meets the definition of insulation (see § 1.44C-2(c)(1)),

(2) The item meets the definition of an other energy-conserving component specified in section 44C(c)(4) see (§ 1.44C-2(d)(4)),

(3) The item meets the definition of solar energy property (see § 1.44C-2(f)), wind energy property (see § 1.44C-2(g)), or geothermal energy property (see § 1.44C-2(h)),

(4) The item meets the definition of a category of energy-conserving component that has been added to the list of approved items pursuant to paragraph (d)(4)(viii) of § 1.44C-2.

(5) The item meets the definition of renewable energy source property that transmits or uses a renewable energy source that has been added to the list of approved renewable energy sources pursuant to paragraph (e)(2) of § 1.44C-2.

(b) *Procedure*—(1) *In general.* A manufacturer of an item desiring to apply under paragraph (a) shall submit the application to the Commissioner of Internal Revenue, Attention: Assistant Commissioner (Technical), TCE, 1111 Constitution Avenue, N.W., Washington, D.C. 20224. Upon being advised by the National Office, orally or in writing, that an adverse decision is contemplated a manufacturer may request a conference. The conference must be held within 21 calendar days from the date of that advice. Procedures for requesting an extension of the 21-day period and notifying the manufacturer of the Service's decision on that request are the same as those applicable to conferences on ruling requests by taxpayers (see section 9.05 of Rev. Proc. 80-20).

(2) *Contents of application.* The application shall include a description of the item (including appropriate design drawings and specifications) and an explanation of the purpose and function of the item. There shall accompany the application a declaration in the following form: "Under penalties of perjury, I declare that I have examined this application, including accompanying documents and, to the best of my knowledge and belief, the facts presented in support of the application are true, correct, and complete." The statement must be signed by the person or persons making the application.

(c) *Effect of certification under paragraph (a).* Certifications granted under paragraph (a)(1), (2), or (3) will be applied retroactively to April 20, 1977. However, certifications granted under paragraph (a)(4) or (5) will be applied retroactively only to the date the applicable energy-conserving component or renewable energy source was added by Treasury decision to the list of qualifying components or sources. Certification of an item under this section means that the applicable definitional requirement of § 1.44C-2 is considered satisfied in the case of any person claiming a residential energy credit with respect to such item. However, it does not relieve manufacturers of the need to establish that their items conform to performance and quality standards (if any) provided under § 1.44C-4 and that their items can reasonably be expected to remain in operation at least 3 years, in the case of insulation and other energy-conserving components, or at least 5 years, in the case of renewable energy source property.

[T.D. 7717, 45 FR 57721, Aug. 29, 1980]

§ 1.44C-6 Procedure and criteria for additions to the approved list of energy-conserving components or renewable energy sources. [Reserved]

RULES FOR COMPUTING CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY

§ 1.46-1 Determination of amount.

(a) *Effective dates*—(1) *In general.* This section is effective for taxable years beginning after December 31, 1975. However, transitional rules under paragraph (g) of this section are effective for certain earlier taxable years.

(2) *Acts covered.* This section reflects changes made by the following Acts of Congress:

Act and Section
Tax Reduction Act of 1975, section 301.
Tax Reform Act of 1976, section 802, 1701, 1703.
Revenue Act of 1978, section 311, 312.
Energy Tax Act of 1978, section 301.

(3) *Prior regulations.* For taxable years beginning before January 1, 1976, see 26 CFR § 1.46-1 (Rev. as of April 1, 1979). Those regulatons do not reflect changes made by Pub. L. 89-384, Pub. L. 89-389, and Pub. L. 91-172.

(b) *General rule.* The amount of investment credit (credit) allowed by

section 38 for the taxable year is the portion of credit available under section 46(a)(1) that does not exceed the limitation based on tax under section 46(a)(3).

(c) *Credit available.* The credit available for the taxable year is the sum of—

(1) Unused credit carried over from prior taxable years under section 46(b) (carryovers),

(2) Amount of credit determined under section 46(a)(2) for the taxable year (credit earned), and

(3) Unused credit carried back from succeeding taxable years under section 46(b) (carrybacks).

(d) *Credit earned.* The credit earned for the taxable year is the sum of the following percentages of qualified investment (as determined under section 46 (c) and (d))—

(1) The regular percentage (as determined under section 46(a)(2)(B)),

(2) For energy property, the energy percentage (as determined under section 46(a)(2)(C)), and

(3) The ESOP percentage (as determined under section 46(a)(2)(E)).

(e) *Designation of credits.* The credit available for the taxable year is designated as follows:

(1) The credit attributable to the regular percentage is the "regular credit".

(2) The credit attributable to the ESOP percentage is the "ESOP credit".

(3) The credit attributable to the energy percentage for energy property other than solar or wind is the "nonrefundable energy credit".

(4) The credit attributable to the energy percentage for solar or wind energy property is the "refundable energy credit".

(f) *Special rules for certain energy property.* Energy property is defined in section 48(l). Under section 46(a)(2)(D), energy property that is section 38 property solely by reason of section 48(l)(1) qualifies only for the energy credit. Other energy property qualifies for both the regular credit (and, if applicable, the ESOP credit) and the energy credit. For limitation on the energy percentage for property financed by industrial development bonds, see section 48(l)(11).

(g) *Transitional rule for regular and ESOP credit*—(1) *In general.* Although section 46(a)(2) was amended by section 301(a)(1) of the Energy Tax Act of 1977 to eliminate the transitional rules under section 46(a)(2)(D), those rules still apply in certain instances. Section 46(a)(2)(D) was added by section 301(a) of the Tax Reduction Act of 1975 and amended by section 802(a) of the Tax Reform Act of 1976.

(2) *Regular credit.* Under section 46(a)(2)(D), the regular credit is 10 percent and applies for the following property: (i) Property to which section 46 (d) does not apply, the construction, reconstruction, or erection of which is completed by the taxpayer after January 21, 1975, but only to the extent of basis attributable to construction, reconstruction, or erection after that date.

(ii) Property to which section 46(d) does not apply, acquired by the taxpayer after January 21, 1975.

(iii) Qualified progress expenditures (as defined in section 46(d)) made after January 21, 1975.

(3) *ESOP credit.* See section 48(m) for transitional rules limiting the period for which the ESOP percentage under section 46(a)(2)(E) applies. For prior statutes, see section 46(a)(2) (B) and (D), as added by section 501 of the Tax Reduction Act of 1975 and amended by section 802 of the Tax Reform Act of 1976.

(4) *Cross reference.* (i) The principles of § 1.48-2 (b) and (c) apply in determining the portion of basis attributable to construction, reconstruction, or erection after January 21, 1975, and in determining the time when property is acquired.

(ii) Section 311 of the Revenue Act of 1978 made the 10 percent regular credit permanent.

(5) *Seven percent credit.* To the extent that, under paragraph (g)(1) of this section, the 10 percent does not apply, the regular credit, in general, is 7 percent. For a special limitation on qualified investment for public utility property (other than energy property), see section 46(c)(3)(A).

(h) *Tax liability limitation*—(1) *In general.* Section 46(a)(3) provides a tax liability limitation on the amount of credit allowed by section 38 (other

than the refundable energy credit) for any taxable year. See section 46(a)(10)(C)(i). Tax liability is defined in paragraph (j) of this section. The excess of available credit over the applicable tax liability limitation for the year is an unused credit which may be carried forward or carried back under section 46(b).

(2) *Regular and ESOP tax liability limitation.* In general, the tax liability limitation for the regular and ESOP credits is the portion of tax liability that does not exceed $25,000 plus a percentage of the excess, as determined under section 46(a)(3)(B).

(3) *Nonrefundable energy credit tax liability limitation.* (i) For nonrefundable energy credit carrybacks to a taxable year ending before October 1, 1978, the tax liability limitation is the portion of tax liability that does not exceed $25,000 plus a percentage of the excess, as determined under section 46(a)(3)(B).

(ii) For a taxable year ending after September 30, 1978, the tax liability limitation for available nonrefundable energy credit is 100 percent of the year's tax liability.

(4) *Alternative limitations.* Alternative limitations apply for certain utilities, railroads, and airlines in determining the regular tax liability limitation and, for nonrefundable energy credit carrybacks to taxable years ending before October 1, 1978, the nonrefundable energy credit tax liability limitation. These alternative limitations do not apply in determining the energy tax liability limitation for a taxable year ending after October 1, 1978. The provisions listed below set forth the alternative limitations:

Code section, type, and years applicable
46(a)(6), Utilities. Taxable years ending in 1975-1978.
46(a)(7),[2] Utilities. Taxable year ending in 1979.
46(a)(8), Railroads and Airlines. Taxable year ending in 1979 or 1980.
46(a)(8),[3] Railroads. Taxable years ending in 1977 or 1978.
46(a)(9),[3] Airlines. Taxable years ending in 1977 or 1978.

(i) [Reserved]

(j) *Tax liability*—(1) *In general.* "Tax liability" for purposes of the regular and ESOP credit and carrybacks of nonrefundable energy credit to a taxable year ending before October 1, 1978, means the liability for tax as defined in section 46(a)(4). For ordering of regular, ESOP, and nonrefundable energy credits, see paragraph (m) of this section. In addition to taxes excluded under section 46(a)(4), tax liability does not include tax resulting from recapture of credit under section 47 and the alternative minimum tax imposed by section 55. See sections 47(c) and 55(c)(1).

(2) *Certain nonrefundable energy credit.* For a taxable year ending after September 30, 1978, "tax liability" for purposes of the nonrefundable energy credit is liability for tax, as defined in section 46(a)(4) and paragraph (j)(1) of this section, reduced by the regular and ESOP credit allowed for the taxable year. Thus, carrybacks of regular or ESOP credit to a taxable year may displace nonrefundable energy carryovers or credit earned taken into account in that year. However, carrybacks of regular, ESOP, or nonrefundable energy credit do not affect refundable energy credit which is treated as an overpayment of tax under section 6401(b). See paragraph (k) of this section.

(k) *Special rule for refundable energy credit.* The amount of the refundable energy credit is determined under the rules of section 46 (other than section 46(a)(3)). However, to permit the refund, the refundable energy credit for purposes of the Internal Revenue Code (other than section 38, part IVB, and chapter 63 of the Code) is treated as allowed by section 39 and not by section 38. The refundable credit is not applied against tax liability for purposes of determining the tax liabil-

[2] Section 46(a)(6) was added by section 301(b)(2) of the Tax Reduction Act of 1975 and redesignated as section 46(a)(7) by section 302(a)(1) of the Tax Reform Act of 1976.

[3] Section 46(a)(7) was amended by section 312(b)(1) of the Revenue Act of 1978.

[3] These provisions were repealed by section 312(b)(2) of the Revenue Act of 1978.

ity limitation for other investment credits. Rather, it is treated as an overpayment of tax under section 6401(b).

(l) *FIFO rule.* If the credit available for a taxable year is not allowed in full because of the tax liability limitation, special rules determine the order in which credits are applied. Under the first-in-first-out rule of section 46(a)(1) (FIFO), carryovers are applied against the tax liability limitation first. To the extent the tax liability limitation exceeds carryovers, credit earned, and carrybacks are then applied.

(m) *Special ordering rule*—(1) *In general.* Under section 46(a)(10)(A), the FIFO rule applies separately—

(i) First, with respect to regular and ESOP credits, and

(ii) Second, with respect to nonrefundable energy credit.

(2) *Regular and ESOP credit.* Under § 1.46-8(c)(9)(ii), regular and ESOP credits available are applied in the following order:

(i) Regular carryovers;

(ii) ESOP carryovers;

(iii) Regular credit earned;

(iv) ESOP credit earned;

(v) Regular carrybacks; and

(vi) ESOP carrybacks.

(3) *Example.* For an example of the order of application of regular and ESOP credits, see § 1.46-8(c)(9)(iii).

(n) *Examples.* The following examples illustrate paragraphs (a) through (m) of this section.

Example (1). (a) Corporation M's regular credit available for its taxable year ending December 31, 1979 is as follows:

Regular carryovers	$5,000
Regular credit earned	10,000
Regular carrybacks	15,000
Credit available	30,000

(b) M's "tax liability" for 1979 is $30,000. M's tax liability limitation for 1979 for the regular credit is $28,000, consisting of $25,000 plus 60 percent of the $5,000 of "tax liability" in excess of $25,000.

(c) The regular carryovers and credit earned are allowed in full. However, only $13,000 of the regular carryback is allowed for 1979. The remaining $2,000 must be carried to the next year to which it may be carried under section 46(b).

Example (2). (a) For its taxable year ending December 31, 1980, corporation N has $30,000 regular credit earned and $9,000 nonrefundable energy credit earned. N has no carryovers to 1980 and no "tax liability" for pre-1980 years.

(b) N's "tax liability" for 1980 for the regular credit is $35,000. N's tax liability limitation for 1980 for the regular credit is $32,000, consisting of $25,000 plus 70 percent of the $10,000 of "tax liability" in excess of $25,000.

(c) The entire regular credit is allowed in 1980.

(d) N's "tax liability" for 1980 for the nonrefundable energy credit is $5,000, consisting of $35,000 less $30,000 regular credit allowed for 1980. N's tax liability limitation for 1980 for the nonrefundable energy credit is 100 percent of $5,000.

(e) $5,000 of the nonrefundable energy credit is allowed for 1980. The remaining $4,000 energy credit is an unused nonrefundable energy credit which must be carried to the next year to which it may be carried under section 46(b).

Example (3). (a) Assume the same facts as in example (2) except that in its taxable year ending December 31, 1981, N earns a regular credit of which it may carry back $2,000 to 1980.

(b) The $30,000 regular credit earned and $2,000 of the regular carryback is allowed for 1980. N's "tax liability" for 1980 for the nonrefundable energy credit is reduced to $3,000, consisting of $35,000 less $32,000 regular credit allowed for 1980. The nonrefundable energy credit allowed for 1980 is reduced to $3,000. The remaining $6,000 is an unused nonrefundable energy credit which must be carried to the next year to which it may be carried under section 46(b).

Example (4). (a) For its taxable year ending December 31, 1980, corporation P's regular credit earned is $20,000. P also has a $9,000 refundable energy credit for 1980. There are no carryovers or carrybacks to 1980.

(b) P's "tax liability" for 1980 for the regular credit is $25,000 which is also the tax liability limitation for the regular credit.

(c) The entire $20,000 regular credit is allowed for 1980. The entire $9,000 refundable energy credit is treated as an overpayment of tax under section 6401(b), even though "tax liability" remains.

Example (5). Assume the same facts as in example (4), except that in the following year P earns a regular credit, $5,000 of which it may carry back to 1980. The $5,000 carryback is allowed in full in 1980.

(o) *Married individuals.* If a separate return is filed by a husband or wife, the tax liability limitation is computed by substituting a $12,500

amount for the $25,000 amount that applies under section 46(a)(3). However, this reduction of the $25,000 amount to $12,500 applies only if the taxpayer's spouse is entitled to a credit under section 38 for the taxable year of such spouse which ends with, or within, the taxpayer's taxable year. The taxpayer's spouse is entitled to a credit under section 38 either because of investment made in qualified property for such taxable year of the spouse (whether directly made by such spouse or whether apportioned to such spouse, for example, from an electing small business corporation, ad defined in section 1371(b)), or because of an investment credit carryback or carryover to such taxable year. The determination of whether an individual is married shall be made under the principles of section 143 and the regulations thereunder.

(p) *Apportionment of $25,000 amount among component members of a controlled group*—(1) *In general.* In determining the tax liability limitation under section 46(a)(3) for corporations that are component members of a controlled group on a December 31, only one $25,000 amount is available to those component members for their taxable years that include that December 31. See subparagraph (2) of this paragraph for apportionment of such amount among such component members. See subparagraph (3) of this paragraph for definition of "component member".

(2) *Manner of apportionment.* (i) In the case of corporations which are component members of a controlled group on a particular December 31, the $25,000 amount may be apportioned among such members for their taxable years that include such December 31 in any manner the component members may select, provided that each such member less than 100 percent of whose stock is owned, in the aggregate, by the other component members of the group on such December 31 consents to an apportionment plan. The consent of a component member to an apportionment plan with respect to a particular December 31 shall be made by means of a statement, signed by a person duly authorized to act on behalf of the consenting member, stating that such member consents to the apportionment plan with respect to such December 31. The statement shall set forth the name, address, employer identification number, and taxable year of each component member of the group on such December 31, the amount apportioned to each such member under the plan, and the location of the Service Center where the statement is to be filed. The consent of more than one component member may be incorporated in a single statement. The statement shall be timely filed with the Service Center where the component member having the taxable year first ending on or after such December 31 files its return for such taxable year and shall be irrevocable after such filing. If two or more component members have the same such taxable year, a statement of consent may be filed by any one of such members. However, if the due date (including any extensions of time) of the return of such member is on or before December 15, 1971, the required statement shall be considered as timely filed if filed on or before March 15, 1972. Each component member of the group on such December 31 shall keep as a part of its records a copy of the statement containing all the required consents.

(ii) An apportionment plan adopted by a controlled group with respect to a particular December 31 shall be valid only for the taxable year of each member of the group which includes such December 31. Thus, a controlled group must file a separate consent to an apportionment plan with respect to each taxable year which includes a December 31 as to which an apportionment plan is desired.

(iii) If the apportionment plan is not timely filed, the $25,000 amount specified in section 46(a)(3) shall be reduced for each component member of the controlled group, for its taxable year which includes a December 31, to an amount equal to $25,000 divided by the number of component members of such group on such December 31.

(iv) If a component member of the controlled group makes its income tax return on the basis of a 52-53-week taxable year, the principles of section 441(f)(2)(A)(ii) and paragraph (b)(1) of § 1.441-2 apply in determining the last day of such taxable year.

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(3) *Definitions of controlled group of corporations and component member of controlled group.* For the purpose of this paragraph, the terms "controlled group of corporations" and "component member" of a controlled group of corporations shall have the same meaning assigned to those terms in section 1563 (a) and (b). For purposes of applying § 1.1563-1(b)(2)(ii)(c), an electing small business corporation shall be treated as an excluded member whether or not it is subject to the tax imposed by section 1378.

(4) *Members of a controlled group filing a consolidated return.* If some component members of a controlled group join in filing a consolidated return pursuant to § 1.1502-3(a)(3), and other component members do not join, then, unless a consent is timely filed apportioning the $25,000 amount among the group filing the consolidated return and the other component members of the controlled group, each component member of the controlled group (including each component member which joins in filing the consolidated return) shall be treated as a separate corporation for purposes of equally apportioning the $25,000 amount under subparagraph (2)(iii) of this paragraph. In that case, the tax liability limitation for the group filing the consolidated return is computed by substituting for the $25,000 amount under section 46(a)(3) the total amount apportioned to each component member that joins in filing the consolidated return. If the affiliated group filing the consolidated return and the other component members of the controlled group adopt an apportionment plan, the affiliated group shall be treated as a single member for the purpose of applying subparagraph (2)(i) of this paragraph. Thus, for example, only one consent executed by the common parent to the apportionment plan is required for the group filing the consolidated return. If any component member of the controlled group which joins in the filing of the consolidated return is an organization to which section 593 applies or a cooperative organization described in section 1381(a), see paragraph (a)(3)(ii) of § 1.1502-3.

(5) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). At all times during 1976 Smith, an individual, owns all the stock of corporations X, Y, and Z. Corporation X files an income tax return on a calendar year basis. Corporation Y files an income tax return on the basis of a fiscal year ending June 30. Corporation Z files an income tax return on the basis of a fiscal year ending September 30. On December 31, 1976, X, Y, and Z are component members of the same controlled group. X, Y, and Z all consent to an apportionment plan in which the $25,000 amount is apportioned entirely to Y for its taxable year ending June 30, 1977 (Y's taxable year which includes December 31, 1976). Such consent is timely filed. For purposes of computing the credit under section 38, Y's tax liability limitation for its taxable year ending June 30, 1977, is so much of Y's tax liability as does not exceed $25,000, plus 50 percent of Y's tax liability in excess of $25,000. X's and Z's limitations for their taxable years ending December 31, 1976, and September 30, 1977, respectively, are equal to 50 percent of X's tax liability for 50 percent of Z's tax liability. On the other hand, if an apportionment plan is not timely filed, X's limitation would be so much of X's tax liability as does not exceed $8,333.33, plus 50 percent of X's liability in excess of $8,333.33, and Y's and Z's limitations would be computed similarly.

Example (2). At all times during 1976, Jones, an individual, owns all the outstanding stock of corporations P, Q, and R. Corporations Q and R both file returns for taxable years ending December 31, 1976. P files a consolidated return as a common parent for its fiscal year ending June 30, 1977, with its two wholly-owned subsidiaries N and O. On December 31, 1976, N, O, P, Q, and R are component members of the same controlled group. No consent to an apportionment plan is filed. Therefore, each member is apportioned $5,000 of the $25,000 amount ($25,000 divided equally among the five members). The tax liability limitation for the group filing the consolidated return (P, N, and O) for the year ending June 30, 1977 (the consolidated taxable year within which December 31, 1976, falls) is computed by using $15,000 instead of the $25,000 amount. The $15,000 is arrived at by adding together the $5,000 amounts apportioned to P, N, and O.

[T.D. 6731, 29 FR 6064, May 8, 1964, as amended by T.D. 6931, 32 FR 14026, Oct. 10, 1967; T.D. 6958, 33 FR 9168, June 21, 1968; T.D. 7181, 37 FR 8063, Apr. 25, 1972; T.D. 7203, 37 FR 17124, Aug. 25, 1972; T.D. 7564, 43 FR 40466, Sept. 12, 1978; T.D. 7636, 44 FR 47048, Aug. 10, 1979; T.D. 7751, 46 FR 1677, Jan. 7, 1981; 46 FR 16100, Mar. 11, 1981]

§ 1.46-2 Carryback and carryover of unused credit.

(a) *Effective date.* This section is effective for taxable years beginning after December 31, 1975. For taxable years beginning before January 1, 1976, see 26 CFR 1.46-2 (Rev. as of April 1, 1979).

(b) *In general.* Under section 46(b)(1), unused credit may be carried back and carried over. Carrybacks and carryovers of unused credit are taken into account in determining the amount of credit available and the credit allowed for the taxable years to which they may be carried. In general, the application of the rules of this section to regular and ESOP credits are separate from their application to nonrefundable energy credits. For example, the limitations on carrybacks and carryovers of unused nonrefundable energy credit under section 46(b)(2) and (3), respectively, differ in amount from the limitations on the regular and ESOP credits because the tax liability limitations for those credits differ. See § 1.46-1(h). For a further example, see the special ordering rule in § 1.46-1(m). Section 46(b) does not apply to the refundable energy credit.

(c) *Unused credit.* If carryovers and credit earned (as defined in § 1.46-1(c)(1)) exceed the applicable tax liability limitation, the excess attributable to credit earned is an unused credit. The taxable year in which an unused credit arises is referred to as the "unused credit year".

(d) *Taxable years to which unused credit may be carried.* An unused credit is a carryback to each of the 3 taxable years preceding the unused credit year and a carryover to each of the 7 taxable years succeeding the unused credit year. An unused credit must be carried first to the earliest of those 10 taxable years. An unused credit then must be carried to each of the other 9 taxable years (in order of time) to the extent that the unused credit was not absorbed during a prior taxable year because of the limitations under section 46(b)(2) and (3).

(e) *Special rule for pre-1971 years*—(1) *In general.* For unused credit years ending before January 1, 1971, unused credit is allowed a 10-year carryover rather than the 7-year carryover. The principles of paragraph (d) of this section apply to this 10-year carryover.

(2) *Cross reference.* For limitations on the taxable years to which unused credit from pre-1971 credit years may be carried, see paragraph (g) of this section.

(f) *Limitations on carrybacks.* Under the FIFO rule to section 46(a)(1), carryovers and credit earned are applied against the tax liability limitation before carrybacks. Thus, carrybacks to a taxable year may not exceed the amount by which the applicable tax liability limitation for that year exceeds the sum of carryovers to and credit earned for that year. Carrybacks from an unused credit year are applied against tax liability before carrybacks from a later unused credit year. To the extent an unused credit cannot be carried back to a particular preceding taxable year, the unused credit must be carried to the next succeeding taxable year to which it may be carried.

(g) *Limitations on carryovers*—(1) *General rule.* Carryovers to a taxable year may not exceed the applicable tax liability limitation for that year. Carryovers from an unused credit year are applied before carryovers from a later unused credit year.

(2) *Exception.* A 10-year carryover from a pre-1971 unused credit year may, under certain circumstances, be postponed to prevent a later-earned 7-year carryover from expiring. This exception does not extend the 10-year carryover period for pre-1971 unused credit. See section 46(b)(1)(D).

(h) *Examples.* The following examples illustrate paragraphs (a) through (g) of this section.

Example (1). (a) Corporation M is organized on January 1, 1977 and files its income tax return on a calendar year basis. Assume the facts set forth in columns (1) and (2) of the following table. The determination of the regular credit allowed for each of the taxable years indicated is set forth in the remaining portions of the table.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Credit available	Tax liability	Percent	Tax liability limitation (remaining from col. (6) on preceding line)	Credit allowed (lower of (1) or (4))	Remaining tax liability limitation ((4)–(5))	Unused credit ((1)–(5)) or (amount absorbed)
1977:							
A. Credit earned	$20,000	$45,000	50	$35,000	$20,000	$15,000	0
B. Carryback from 1978	*15,000			[15,000]	15,000		
1978:							
A. Credit earned	80,000	55,000	50	40,000	40,000	0	$20,000
Carryback to 1977							(*15,000)
Carryover to 1979							(*5,000)
1979:							
A. Carryover from 1978	*5,000	50,000	60	40,000	6,000	35,000	
B. Credit earned	50,000			[35,000]	35,000	0	15,000
Carryover to 1980							(*15,000)
1980:							
A. Carryover from 1979	*15,000	55,000	70	46,000	15,000	31,000	
B. Credit earned	25,000			[31,000]	25,000	6,000	0

*For line "A" each year: Lesser of (1) tax liability or (2) $25,000 + (percentage in col. (3) × [col. (2) − $25,000]). See, § 1.46-1(h). For other lines: Amount in col. (6) on preceding line.

Example (2). (a) Assume the same facts as in example (1) except for 1979 M earns a $35,000 nonrefundable energy credit. The following table shows the determinations for each year.

	(1)	(2)		(3)	(4)	(5)	(6)	(7)
		Tax liability						
	Credit available	(a) Regular	(b) Energy ((2)(a)–(5)(R))	Percent	Tax liability limitation* (remaining from col. (6) on preceding line)	Credit allowed (lower of (1) or (4))	Remaining tax liability limitation ((4)–(5))	Unused credit ((1)–(5)) or (amount absorbed)
1977:								
Regular:								
A. Credit earned	$20,000	$45,000		50	$35,000	$20,000R	$15,000	0
B. Carryback from 1978	*15,000				[15,000]	15,000R	0	
1978:								
Regular:								
A. Credit earned	60,000	55,000		50	40,000	40,000R	0	$20,000
Carryback to 1977								(*15,000)
Carryover to 1979								(*5,000)
Energy:								
A. Carryback from 1979	*15,000		$15,000	100	15,000	15,000E	0	
1979:								
Regular:								
A. Carryover from 1978	*5,000	50,000		60	40,000	5,000R	35,000	
B. Credit earned	50,000				[35,000]	35,000R	0	15,000
Carryover to 1980								(*15,000)
Energy:								
A. Credit earned	35,000		10,000	100	10,000	10,000E	0	25,000
Carryback to 1978								(*15,000)
Carryover to 1980								(*10,000)
1980:								
Regular:								
A. Carryover from 1979	*15,000	55,000		70	46,000	15,000R	31,000	
B. Credit earned	25,000				[31,000]	25,000R	6,000	0
Energy:								
A. Carryover from 1979	*10,000		15,000	100	15,000	10,000E	5,000	

*See footnote to the chart in example (1).

(b) Although, in general, a nonrefundable energy credit may be carried back to taxable years ending before October 1, 1978, in this example the unused nonrefundable energy credit from 1979 may not be absorbed in 1977. The 1977 tax liability limitation for the nonrefundable energy credit is the same as it is for the regular credit, reduced by regular credit previously allowed for 1977. See §§ 1.46-1(h)(3) and 1.46-1(m).

Example (3). (a) Assume the same facts as in example (2) except M has regular credit of $37,000 for 1981 and M's tax liability for 1981 is $32,500. The determinations for 1980 and 1981 are set forth in the following table.

	(1)	(2)		(3)	(4)	(5)	(6)	(7)
		Tax liability						
	Credit available	(a) Regular	(b) Energy ((2)–(5)(R))	Percent	Tax liability limitation* (remaining from col. (6) on preceding line)	Credit allowed (lower of (1) or (4))	Remaining tax liability limitation ((4)–(5))	Unused credit ((1)–(5)) or (amount absorbed)
1979 (restated):								
Energy:								
To be carried over								$10,000
Carryover to 1980								(*9,000)
Carryover to 1981								(*1,000)
1980 (restated):								
Regular:								
A. Carryover from 1979	$15,000	$55,000		70	$46,000	$15,000R	$31,000	
B. Credit earned	*25,000				[31,000]	25,000R	6,000	0
C. Carryback from 1981	*6,000				[6,000]	6,000R	0	
Energy:								
A. Carryover from 1979	*9,000		$9,000	100	9,000	9,000E		
1981: Regular:								
A. Credit earned	37,000	32,500		80	31,000	31,000R	0	6,000
Carryback to 1980								(*6,000)
Energy:								
A. Carryover from 1979	*1,000		1,500	100	1,500	1,000E	500	0

*See footnote to chart under example (1).

(b) Allowance of the regular carryback in 1980 from 1981 requires that the computations for 1980 be restated. The energy tax liability limitation for 1980 is reduced from $15,000 (as determined in example (2)) to $9,000. Thus, $1,000 of the $10,000 energy credit allowed for 1980 is displaced by the regular carryback. That amount may not be carried back because there is no remaining energy tax liability limitation for the prior 3 years (see table in example (2)). It may be carried over to 1981 and allowed in full in that year.

(i) [Reserved]

(j) *Electing small business corporation.* A shareholder of an electing small business corporation (as defined in section 1371(b)) may not take into account unused credit of the corporation attributable to unused credit years for which the corporation was not an electing small business corporation. However, a taxable year for which the corporation is an electing small business corporation is counted as a taxable year for determining the taxable years to which that unused credit may be carried.

(k) *Periods of less than 12 months.* A fractional part of a year that is considered a taxable year under sections 441(b) and 7701(a)(23) is treated as a preceding or succeeding taxable year for determining under section 46(b) the taxable years to which an unused credit may be carried.

(l) *Corporate acquisitions.* For carryover of unused credits in the case of certain corporate acquisitions, see section 381(c)(23).

(Sections 7805 (68A Stat. 917, 26 U.S.C 7805) and 38(b) (76 Stat. 962, 26 U.S.C. 38))

[T.D. 7751, 46 FR 1679, Jan. 7, 1981]

§ 1.46-3 Qualified investment.

(a) *In general.* (1) With respect to any taxable year, the qualified investment of the taxpayer is the aggregate (expressed in dollars) of (i) the applicable percentage of the basis of each new section 38 property placed in service by the taxpayer during such taxable year, plus (ii) the applicable percentage of the cost of each used section 38 property placed in service by the taxpayer during such taxable year. With respect to any section 38 property, qualified investment means the applicable percentage of the basis (or cost) of such property. Section 38 property placed in service by the taxpayer during the taxable year includes the taxpayer's share of the basis (or cost) of section 38 property placed in service by a partnership in the taxable year of such partnership ending with or within the taxpayer's taxable year. In the case of a shareholder of an electing small business corporation (as defined in section 1371(b)), or a beneficiary of an estate or trust, see §§ 1.48-5 and 1.48-6, respectively, for apportionment of the basis (or cost) of section 38 property placed in service by such corporation, estate, or trust. For the definitions of new section 38 property and used section 38 property, see §§ 1.48-2 and 1.48-3, respectively.

(2) The basis (or cost) of section 38 property placed in service during a taxable year shall not be taken into account in determining qualified investment for such year if such property is disposed of or otherwise ceases to be section 38 property during such year, except where § 1.47-3 applies. Thus, if individual A places in service during a taxable year section 38 property and later in the same year sells such property, the basis (or cost) of such property shall not be taken into account in determining A's qualified investment. On the other hand, if A places in service section 38 property during a taxable year and dies later in the same year, the basis (or cost) of such property would be taken into account in computing qualified investment. Similarly, if section 38 property is destroyed by fire in the same year in which it is placed in service and paragraph (h) of this section applies to reduce the basis (or cost) of replacement property, the basis (or cost) of the destroyed property would be taken into account in computing qualified investment. In order to determine whether section 38 property is disposed of or otherwise ceases to be section 38 property see § 1.47-2.

(3) Qualified investment is reduced in the case of property which is "public utility property" (see paragraph (h) of this section), and in the case of property of organizations to which section 593 applies, regulated investment companies or real estate investment trusts subject to taxation under subchapter M, chapter 1 of the Code, and cooperative organizations described in section 1381(a) (see § 1.46-4).

(b) *Applicable percentage.* The applicable percentage to be applied to the basis (or cost) of property is 33⅓ percent if the estimated useful life of the property is 3 years or more but less than 5 years; 66⅔ percent if the estimated useful life is 5 years or more but less than 7 years; or 100 percent if the estimated useful life is 7 years or more. In the case of property which is not described in section 50, the preceding sentence shall be applied by substituting "4 years' for "3 years", "6 years" for "5 years", and "8 years" for "7 years". The provisions of this paragraph may be illustrated by the following example:

Example. Corporation Y acquires and places in service during 1972 the following new and used section 38 properties:

Property	Estimated useful life (years)	Basis (or cost)
A (new)	4	$60,000
B (new)	10	90,000
C (new)	6	150,000
D (used)	3	30,000

Corporation Y's qualified investment for 1972 is $220,000 determined in the following manner:

Property	Basis (or cost)	Applicable percentage	Qualified investment
A	$60,000	33⅓	$20,000
B	90,000	100	90,000
C	150,000	66⅔	100,000
D	30,000	33⅓	10,000
Total			220,000

(c) *Basis or cost.* (1) The basis of any new section 38 property shall be determined in accordance with the general rules for determining the basis of property. Thus, the basis of property would generally be its cost (see section 1012), unreduced by the adjustment to basis provided by section 48(g)(1) with respect to property placed in service before January 1, 1964, and any other adjustment to basis, such as that for depreciation, and would include all items properly included by the taxpayer in the depreciable basis of the property, such as installation and freight costs. However, for purposes of determining qualified investment, the basis of new section 38 property constructed, reconstructed, or erected by the taxpayer shall not include any depreciation sustained with respect to any other property used in the construction, reconstruction, or erection of such new section 38 property. (See paragraph (b)(4) of § 1.48-1.) If new section 38 property is acquired in exchange for cash and other property in a transaction described in section 1031 in which no gain or loss is recognized, the basis of the newly acquired property for purposes of determining qualified investment would be equal to the adjusted basis of the other property plus the cash paid. See § 1.48-4 for the basis of property to a lessee where the lessor has elected to treat such lessee as a purchaser.

(2) The cost of any used section 38 property shall be determined in accordance with paragraph (b) of § 1.48-3. However, the aggregate cost of used section 38 property which may be taken into account in any taxable year in computing qualified investment cannot exceed $50,000 (see paragraph (c) of § 1.48-3).

(3) For reduction in the basis (or cost) of certain property which replaces other property which was destroyed or damaged by fire, storm, shipwreck, or other casualty, or which was stolen, see paragraph (h) of this section.

(d) *Placed in service.* (1) For purposes of the credit allowed by section 38, property shall be considered placed in service in the earlier of the following taxable years:

(i) The taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins; or

(ii) The taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity.

Thus, if property meets the conditions of subdivision (ii) of this subparagraph in a taxable year, it shall be considered placed in service in such year notwithstanding that the period for depreciation with respect to such property begins in a succeeding taxable year because, for example, under the taxpayer's depreciation practice such property is accounted for in a multiple asset account and depreciation is computed under an "averaging convention" (see § 1.167(a)-10), or depreciation with respect to such property is computed under the completed contract method, the unit of production method, or the retirement method.

(2) In the case of property acquired by a taxpayer for use in his trade or business (or in the production of income), the following are examples of cases where property shall be considered in a condition or state of readiness and availability for a specifically assigned function:

(i) Parts are acquired and set aside during the taxable year for use as replacements for a particular machine (or machines) in order to avoid operational time loss.

(ii) Operational farm equipment is acquired during the taxable year and it is not practicable to use such equipment for its specifically assigned function in the taxpayer's business of farming until the following year.

(iii) Equipment is acquired for a specifically assigned function and is oper-

ational but is undergoing testing to eliminate any defects.

However, fruit-bearing trees and vines shall not be considered in a condition or state of readiness and availability for a specifically assigned function until they have reached an income-producing stage. Moreover, materials and parts acquired to be used in the construction of an item of equipment shall not be considered in a condition or state of readiness and availability for a specifically assigned function.

(3) Notwithstanding subparagraph (1) of this paragraph, property with respect to which an election is made under § 1.48-4 to treat the lessee as having purchased such property shall be considered placed in service by the lessor in the taxable year in which possession is transferred to such lessee.

(4)(i) The credit allowed by section 38 with respect to any property shall be allowed only for the first taxable year in which such property is placed in service by the taxpayer. The determination of whether property is section 38 property in the hands of the taxpayer shall be made with respect to such first taxable year. Thus, if a taxpayer places property in service in a taxable year and such property does not qualify as section 38 property (or only a portion of such property qualifies as section 38 property) in such year, no credit (or a credit only as to the portion which qualifies in such year) shall be allowed to the taxpayer with respect to such property notwithstanding that such property (or a greater portion of such property) qualifies as section 38 property in a subsequent taxable year. For example, if a taxpayer places property in service in 1963 and uses the property entirely for personal purposes in such year, but in 1964 begins using the property in a trade or business, no credit is allowable to the taxpayer under section 38 with respect to such property. See § 1.48-1 for the definition of section 38 property.

(ii) Notwithstanding subdivision (i) of this subparagraph, if, for the first taxable year in which property is placed in service by the taxpayer, the property qualifies as section 38 property but the basis of the property does not reflect its full cost for the reason that the total amount to be paid or incurred by the taxpayer for the property is indeterminate, a credit shall be allowed to the taxpayer for such first taxable year with respect to so much of the cost as is reflected in the basis of the property as of the close of such year, and an additional credit shall be allowed to the taxpayer for any subsequent taxable year with respect to the additional cost paid or incurred during such year and reflected in the basis of the property as of the close of such year. The estimated useful life used in computing each additional credit with respect to the property shall be the same as the estimated useful life used in computing the credit for the first taxable year in which the property was placed in service by the taxpayer. Assume, for example, that in 1964 X Corporation, a utility company which makes its return on the basis of a calendar year, enters into an agreement with Y Corporation, a builder, to construct certain utility facilities for a housing development built by Y. Assume further that part of the funds for the construction of the utility facilities is advanced by Y under a contract providing that X will repay the advances over a 10-year period in accordance with an agreed formula, after which no further amounts will be repayable by X even though the full amount advanced by Y has not been repaid. Assuming that the utility facilities are placed in service in 1964 and qualify as section 38 property, X is allowed a credit for 1964 with respect to its basis in the utility facilities at the close of 1964. For each succeeding taxable year X is allowed an additional credit with respect to the increase in the basis of the utility facilities resulting from the repayments to Y during such year.

(e) *Estimated useful life*—(1)(i) *In general.* With respect to assets placed in service by the taxpayer during any taxable year, for the purpose of computing qualified investment the estimated useful lives assigned to all assets which fall within a particular guideline class (within the meaning of Revenue Procedure 62-21) may be determined, at the taxpayer's option, under either subparagraph (2) or (3)

of this paragraph. Thus, the taxpayer may assign estimated useful lives to all the assets falling in one guideline class in accordance with subparagraph (2) of this paragraph, and may assign estimated useful lives to all the assets falling within another guideline class in accordance with subparagraph (3) of this paragraph. See subparagraphs (4) and (5) of this paragraph for determination of estimated useful lives of assets not subject to subparagraph (2) or (3) of this paragraph.

(ii) Except as provided in subparagraph (7), this paragraph shall not apply to property described in section 50.

(2) *Class life system.* The taxpayer may assign to each asset falling within a guideline class, which is placed in service during the taxable year, the class life of the taxpayer for the guideline class for such year as determined under section 4, Part II of Revenue Procedure 62-21. The preceding sentence may be applied to the assets falling within a guideline class irrespective of whether the taxpayer uses single asset accounts or multiple asset accounts in computing depreciation with respect to such assets and irrespective of whether the taxpayer chooses to have his depreciation allowance with respect to such assets examined under the rules provided in Revenue Procedure 62-21.

(3) *Individual useful life system.* (i) The taxpayer may assign an individual estimated useful life to each asset falling within a guideline class which is placed in service during the taxable year. With respect to the assets falling within the guideline class which are placed in single asset accounts for purposes of computing depreciation, the estimated useful life used for each asset for that purpose shall be used in determining qualified investment. With respect to the assets falling within the guideline class which are placed in multiple asset accounts (including a guideline class account described in Revenue Procedure 62-21) for which a group, classified, or composite rate is used in computing depreciation (or in single asset accounts for which an average life rate is used), the determination of estimated useful life for each asset in the account shall be made individually on the best estimate obtainable on the basis of all the facts and circumstances. The individual estimated useful lives used for all the assets placed in a multiple asset account, when viewed together, must be consistent with the group, classified, or composite life used for the account for purposes of computing depreciation.

(ii) In determining the individual estimated useful lives of assets similar in kind contained in a multiple asset account (or in single asset accounts for which an average life rate is used), the taxpayer may (*a*) assign to each of such assets the average useful life of such assets used for purposes of computing depreciation, or (*b*) assign separate lives to such assets based on the estimated range of years taken into consideration in establishing the average useful life. Thus, for example, if a taxpayer places nine similar trucks with an average estimated useful life of 7 years, based on an estimated range of 6 to 8 years (two trucks with a useful life of 6 years, five trucks with a useful life of 7 years, and two trucks with a useful life of 8 years), in a multiple asset account for which a group rate is used in computing depreciation, he may either assign a useful life of 6 years to two of the trucks, 7 years to five of the trucks, and 8 years to two of the trucks, or he may assign the average useful life of the trucks (7 years) to each of the nine trucks. Likewise, if a taxpayer places 100 similar telephone poles with an average useful life of 28 years, based on an estimated range of 3 to 40 years (two with a useful life of less than 4 years, three with a useful life of 4 to 6 years, four with a useful life of 6 to 8 years, and 91 with a useful life of more than 8 years), in a multiple asset account for which a group rate is used in computing depreciation, he may either assign useful lives corresponding to the estimated range of years of the poles (i.e., a useful life of less than 4 years to two of the poles, etc.), or he may assign the average useful life of the poles (28 years) to each of the poles.

(iii) In the case of "mass assets" (as defined in paragraph (e)(4) of § 1.47-1) for which the taxpayer is permitted to use an appropriate mortality disper-

sion table (including a standard mortality dispersion table) under paragraph (e)(2) of § 1.47-1 (determined without regard to paragraph (e)(2)(ii) thereof), the taxpayer may use such table for purposes of determining estimated useful lives by assigning, under subdivision (ii) (*b*) of this subparagraph, separate lives to such assets based on the estimated range of years taken into consideration in establishing the average useful life. If a taxpayer uses a standard mortality dispersion table for any taxable year, such table must be used for all subsequent taxable years unless the taxpayer obtains the consent of the Commissioner to change.

(iv) For purposes of subdivision (ii) of this subparagraph, assets (other than "mass assets") shall not be considered as "similar in kind" in respect of other assets unless all such assets are substantially of the same value, nor shall used section 38 property be considered as "similar in kind" to new section 38 property.

(4) *Useful life of property subject to amortization.* In the case of property with respect to which amortization in lieu of depreciation is allowable, the term over which amortization deductions are taken shall be considered as the estimated useful life of such property.

(5) *Useful life of property subject to certain methods of depreciation.* If a taxpayer is using a method of depreciation, such as the unit of production or retirement method, which does not measure the useful life of the property in terms of years, he must estimate such useful life in years in order to compute his qualified investment.

(6) *Record requirements.* The taxpayer shall maintain sufficient records to determine whether section 47 (relating to certain dispositions, etc., of section 38 property) applies with respect to any asset.

(7) *Section 50 property.* (i) The provisions of this subparagraph and subparagraphs (4) and (6) of this paragraph shall apply to property which is described in section 50.

(ii) The estimated useful life of property for purposes of computing qualified investment shall be the useful life used or to be used by the taxpayer in computing the allowance for depreciation with respect to such property under section 167 for the taxable year in which the property is placed in service. Thus, if property is placed in service by a taxpayer in a taxable year but the period for depreciation with respect to such property does not begin until a succeeding taxable year (see paragraph (d)(1) of this section), the estimated useful life for purposes of computing qualified investment must be the estimated useful life that the taxpayer uses in computing the allowance for depreciation. See subdivision (iv) of this subparagraph for rules for determining the estimated useful life of property with respect to which the allowance for depreciation under section 167 is computed under the unit of production method, the income-forecast method, or any other method which does not measure the useful life of the property in terms of years.

(iii) (*a*) The estimated useful life of any section 38 property to which an election under section 167(m) applies shall be the asset depreciation period selected for such property under § 1.167(a)-11(b)(4), whether or not such property constitutes mass assets (as defined in § 1.47-1(e)(4)).

(*b*) The estimated useful life of any section 38 property to which an election under section 167(m) does not apply and which is placed in a multiple asset account for which a group, classified, or composite rate is used in computing depreciation (or in single asset accounts for which an average life rate is used) shall be determined individually for each asset on the best estimate obtainable on the basis of all the facts and circumstances. The individual estimated useful life for each asset placed in a multiple asset account (including a mass asset account) must be the same as the useful life of such asset used in determining the group, classified, or composite life for the account for purposes of computing depreciation. The individual estimated useful lives of assets similar in kind may be determined in accordance with subdivisions (ii) and (iv) of subparagraph (3) of this paragraph. In the case of mass assets, subdivision (iii) of

subparagraph (3) of this paragraph shall apply.

(iv) [Reserved]

(f) *Partnerships*—(1) *In general.* In the case of a partnership, each partner shall take into account separately, for his taxable year with or within which the partnership taxable year ends, his share of the basis of partnership new section 38 property and his share of the cost of partnership used section 38 property placed in service by the partnership during such partnership taxable year. Each partner shall be treated as the taxpayer with respect to his share of the basis of partnership new section 38 property and his share of the cost of partnership used section 38 property. The estimated useful life to each partner of such property shall be deemed to be the estimated useful life of the property in the hands of the partnership. Partnership section 38 property shall not, by reason of each partner taking his share of the basis or cost into account, lose its character as either new section 38 property or used section 38 property, as the case may be.

(2) *Determination of partner's share.* (i) Each partner's share of the basis (or cost) of any section 38 property shall be determined in accordance with the ratio in which the partners divide the general profits of the partnership (that is, the taxable income of the partnership as described in section 702(a)(9)) regardless of whether the partnership has a profit or a loss for its taxable year during which the section 38 property is placed in service. However, if the ratio in which the partners divide the general profits of the partnership changes during the taxable year of the partnership, the ratio effective for the date on which the property is placed in service shall apply.

(ii) Notwithstanding subdivision (i) of this subparagraph, if all related items of income, gain, loss, and deduction with respect to any item of partnership section 38 property are specially allocated in the same manner and if such special allocation is recognized under section 704 (a) and (b) and paragraph (b) of § 1.704-1, then each partner's share of the basis of such item of new section 38 property or the cost of such item of used section 38 property shall be determined by reference to such special allocation effective for the date on which the property is placed in service.

(iii) Notwithstanding subdivisions (i) and (ii) of this subparagraph, if with respect to a partnership's taxable year the conditions set forth in (*a*) through (*c*) of this subdivision are satisfied with respect to a partner, then such partner shall not take into account the basis (or cost) of any section 38 property placed in service by the partnership during such taxable year. The conditions referred to in the preceding sentence are:

(*a*) Such partner's interest in the general profits of the partnership during the taxable year is 5 percent or less;

(*b*) Under the partnership agreement, such partner will retire from the partnership during the taxable year or within 7 years after the end of such year; and

(*c*) The partnership agreement provides that the basis (or cost) of section 38 property placed in service by the partnership during the taxable year shall not be taken into account by a partner described in (*a*) and (*b*) of this subdivision.

Any basis (or cost) of section 38 property which is not taken into account by a partner because of the provisions of this subdivision shall be taken into account by the other partners in accordance with subdivision (i) of this subparagraph.

(3) *Examples.* This paragraph may be illustrated by the following examples:

Example (1). Partnership ABCD acquires and places in service on January 1, 1962, an item of new section 38 property, and acquires and places in service on September 1, 1962, another item of new section 38 property. The ABCD partnership and each of its partners reports income on the basis of the calendar year. Partners A, B, C, and D share partnership profits equally. Each partner's share of the basis of each new partnership section 38 property is 25 percent.

Example (2). Assume the same facts as in example (1) and the following additional facts: A dies on June 30, 1962, and B purchases A's interest as of such date. Each partner's share of the profits from January

1 to June 30 is 25 percent. From July 1 to December 31, B's share of the profits is 50 percent, and C and D's share of the profits is 25 percent each. For A's last taxable year (January 1 to June 30, 1962), A shall take into account 25 percent of the basis of the section 38 property placed in service on January 1. B shall take into account 25 percent of the basis of the section 38 property placed in service on January 1 and 50 percent of the basis of the section 38 property placed in service on September 1. C and D shall each take into account 25 percent of the basis of each new section 38 property placed in service by the partnership in 1962.

Example (3). Partnership MR is engaged in the business of renting soda fountain equipment and icemakers to restaurants. The partnership makes no elections under § 1.48-4 to treat its lessees as having purchased such property. Under the terms of the partnership agreement, the income, gain or loss on disposition, depreciation, and other deductions attributable to the icemakers are specially allocated 70 percent to partner M and 30 percent to partner R. In all other respects M and R share profits and losses equally. If the special allocation with respect to the icemakers is recognized under section 704 (a) and (b) and paragraph (b) of § 1.704-1, the basis (or cost) of the icemakers which qualify as partnership section 38 property shall be taken into account 70 percent by M and 30 percent by R. The basis (or cost) of partnership section 38 property not subject to the special allocation shall be taken into account equally by M and R.

Example (4). Assume the same facts as in example (3) and the following additional facts: During November 1962, the partnership, which reports its income on the basis of a fiscal year ending May 31, acquires and places in service two items which qualify as new section 38 property, an icemaker and a soda fountain. The icemaker has an estimated useful life of 8 years to the partnership and a basis of $1,000. The soda fountain has an estimated useful life of 6 years to the partnership and a basis of $600. Partner M also owns and operates a business as a sole proprietorship and reports income on the calendar year basis. During 1963, M acquires and places in service in his sole proprietorship a machine which qualifies as new section 38 property. This machine has an estimated useful life of 4 years and a basis of $300. M owns no interest in any other partnerships, electing small business corporations, estates, or trusts. M's total qualified investment for 1963 is $1,000, computed as follows:

Property	Estimated useful life	Basis	M's share of basis	Applicable percentage	Qualified investment
Partnership MR					
Icemaker	8	$1,000	$700	100	$700
Soda fountain	6	600	300	66⅔	200
Sole proprietorship					
Machine	4	300		33⅓	100
Total					1,000

(g) *Public utility property*—(1) *In general*—(i) *Scope of paragraph.* This paragraph only applies to property described in section 50. For rules relating to public utility property not described in section 50, see 26 CFR Part 1, § 1.46-3(g) (as revised April 1, 1977). This paragraph does not reflect amendments to section 46(c) made after enactment of the Revenue Act of 1971.

(ii) *Amount of qualified investment.* A taxpayer's qualified investment in section 38 property that is public utility property is ⅘ of the amount otherwise determined under this section.

(2) *Meaning and uses of certain terms.* For purposes of this paragraph—

(i) *Public utility property.* "Public utility property" is property used by a taxpayer predominantly in a trade or business that is a public utility activity and property that is nonregulated communication property.

(ii) *Public utility activity.* A "public utility activity" is any activity in which the goods or services described in section 46(c)(3)(B) (i), (ii), or (iii) are furnished or sold at regulated rates. If property is used by a taxpayer both in a public utility activity and in another activity, the characterization of such property is based on the predominant use of such property during the taxable year in which it is placed in service.

(iii) *Regulated rates.* A taxpayer's rates are "regulated" if they are estab-

lished or approved on a rate-of-return basis. Rates regulated on a rate-of-return basis are an authorization to collect revenues that cover the taxpayer's cost of providing goods or services, including a fair return on the taxpayer's investment in providing such goods or services, where the taxpayer's costs and investment are determined by use of a uniform system of accounts prescribed by the regulatory body. A taxpayer's rates are not "regulated" if they are established or approved on the basis of maintaining competition within an industry, insuring adequate service to customers of an industry, or charging "reasonable" rates within an industry since the taxpayer is not authorized to collect revenues based on the taxpayer's cost of providing goods or services. Rates are considered to have been "established or approved" if a schedule of rates is filed with a regulatory body that has the power to approve such rates, even though the regulatory body takes no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer.

(iv) *Nonregulated communication property.* "Nonregulated communication property" is property that is clearly the same type of property (and is used by the taxpayer predominantly for the same type of communication purposes) as communication property, but it is used by the taxpayer predominantly in a trade or business that is not a public utility activity. For purposes of this paragraph (g)(2) (iv), of this section, communication property is property ordinarily used for communication purposes by persons who provide regulated telephone or microwave communication services described in section 46(c)(3)(B)(iii). The determination of whether property is clearly of this same type and is used predominantly for these same communication purposes as communication property is made on the basis of the facts and circumstances of each particular case, including the current state of technology in the communications industry and the range and type of services permitted or required to be provided by the regulated telephone and microwave communication industry. As of 1978, wires or cables used predominantly to distribute to subscribers the signals of one or more television broadcast stations or cablecast stations (such as in a CATV system) are not used for the same type of communication purposes as communication property. Communication property includes microwave transmission equipment, private communication equipment (other than land mobile radio equipment for which the operator must obtain a license from the Federal Communications Commission), private switchboard (PBX) equipment, communications terminal equipment connected to telephone networks, data transmission equipment, and communications satellites. Communication property does not include (as of 1978) computer terminals or facsimile reproduction equipment that is connected to telephone lines to transmit data. It also does not include office furniture stands for communication property, tools, repair vehicles, and similar property, even if such property is exclusively used in providing regulated telephone or microwave communication services.

(3) *Leased property.* Public utility property includes property which is leased to others by a taxpayer where the leasing of such property is part of the lessor's public utility activity. Thus, such leased property is public utility property even though the lessee uses such property in an activity which is not a public utility activity, and whether or not the lessor of such property makes a valid election under § 1.48-4 to treat the lessee as having purchased such property for purposes of the credit allowed by section 38. Property leased by a lessor, where the leasing is not part of a public utility activity, to a lessee who uses such property predominantly in a public utility activity is public utility property for purposes of computing the lessor's or lessee's qualified investment with respect to such property.

(4) *Property used in both the production or transmission of gas and the local distribution of gas.* (i) With respect to properties of a taxpayer engaged in both the production or transmission of gas and the local distribution of gas, section 38 property shall be considered as used predominantly

in the trade or business of the furnishing or sale of gas through a local distribution system if expenditures for such property are chargeable to any of the following accounts under either the uniform system of accounts prescribed for natural gas companies (class A and class B) by the Federal Power Commission, effective January 1, 1961, or the uniform system of accounts for class A and B gas utilities adopted in 1958 by the National Association of Railroad and Utility Commissioners (or would be chargeable to any of the following accounts if the taxpayer used either of such systems):

(*a*) Accounts 360 through 363, inclusive (Local Storage Plant), or

(*b*) Accounts 374 through 387, inclusive (Distribution Plant).

(ii) If expenditures for section 38 property are chargeable (or would be chargeable) to any of the following accounts under either of the systems named in subdivision (i) of this subparagraph, the determination of whether or not such property is used predominantly in the trade or business of the furnishing or sale of gas through a local distribution system shall be made under all the facts and circumstances relating to the actual use of such property in the year such property is placed in service:

(*a*) Accounts 304 through 320, inclusive (Manufactured Gas Production Plant), or

(*b*) Accounts 389 through 399, inclusive (General Plant).

For example, if an office machine is used 55 percent of the time for billing customers of the taxpayer's local distribution system in the year in which it is placed in service, such office machine shall be considered as used predominantly in the trade or business of the furnishing or sale of gas through a local distribution system.

(5) *Certain submarine cable property.* In the case of any interest in a submarine cable circuit which is property described in section 50 used to furnish telegraph service between the United States and a point outside the United States of a taxpayer engaged in furnishing international telegraph service (if the rates for such furnishing have been established or approved by a governmental unit, agency, instrumentality, commission, or similar body described in subparagraph (2) of this paragraph), the qualified investment shall not exceed the qualified investment attributable to so much of the interest of the taxpayer in the circuit as does not exceed 50 percent of all interests in the circuit.

(h) *Certain replacement property.* (1)(i) If section 38 property is placed in service by the taxpayer to replace property (whether or not section 38 property) similar or related in service or use, which was destroyed or damaged before August 16, 1971, by fire, storm, shipwreck, or other casualty, or was stolen before such date, then for purposes of paragraph (a) of this section the basis (or cost) of the replacement section 38 property otherwise determined under paragraph (c) of this section shall be reduced by an amount equal to the lesser of—

(*a*) The amount of money, or the fair market value of other property, received as compensation, by insurance or otherwise, for the property which was destroyed, damaged, or stolen, or

(*b*) The adjusted basis of such destroyed, damaged, or stolen property (immediately before such destruction, damage, or theft).

(ii) For purposes of subdivision (i) of this subparagraph—

(*a*) Section 38 property placed in service after the due date (including extensions of time thereof) for filing the taxpayer's income tax return for the taxable year in which the other property was destroyed, damaged, or stolen shall not be considered as replacement section 38 property, and

(*b*) If the property which is destroyed, damaged, or stolen, is leased property, no other leased property shall be considered as replacement property with respect to the property destroyed, damaged, or stolen, in any case in which the lessor makes or made an election under section 48(d) (relating to election with respect to certain leased property) with respect to either the property destroyed, damaged, or stolen, the other leased property, or both.

(2) Subparagraph (1) of this paragraph shall not apply to replacement property if the reduction, under such

subparagraph (1), in the basis (or cost) of such replacement property is less than the excess of—

(i) The qualified investment with respect to the destroyed, damaged, or stolen property, over

(ii) The recomputed qualified investment with respect to such property (determined under the principles of paragraph (a) of § 1.47-1).

(3) This paragraph may be illustrated by the following examples:

Example (1). (i) A acquired and placed in service on January 1, 1962, machine No. 1, which qualified as section 38 property, with a basis of $30,000 and an estimated useful life of 6 years. The amount of qualified investment with respect to such machine was $20,000. On January 2, 1963, machine No. 1 is completely destroyed by fire. On January 1, 1963, the adjusted basis of such machine in A's hands is $24,500. On November 1, 1963, A receives $23,000 in insurance proceeds as compensation for the destroyed machine, and on December 15, 1963, A acquires and places in service machine No. 2, which qualifies as section 38 property, with a basis of $41,000 and an estimated useful life of 6 years to replace machine No. 1.

(ii) Under subparagraph (1) of this paragraph, the $41,000 basis of machine No. 2 is reduced, for purposes of paragraph (a) of this section, by $23,000 (that is, the $23,000 insurance proceeds since such amount is less than the $24,500 adjusted basis of machine No. 1 immediately before it was destroyed) to $18,000 since such reduction (that is, $23,000) is greater than the $20,000 reduction in qualified investment which would be made if paragraph (a) of § 1.47-1 were to apply to machine No. 1 ($20,000 qualified investment less zero recomputed qualified investment).

Example (2). (i) The facts are the same as in example (1) except that on November 1, 1963, A receives only $19,000 in insurance proceeds as compensation for the destroyed machine.

(ii) The $41,000 basis of machine No. 2 is not reduced, for purposes of paragraph (a) of this section, under this paragraph since the $19,000 reduction which would have been made under this paragraph had it applied (that is, the $19,000 insurance proceeds since such amount is less than the $24,500 adjusted basis of machine No. 1 immediately before it was destroyed) is less than the $20,000 reduction in qualified investment which is made since paragraph (a) of § 1.47-1 applies to machine No. 1 ($20,000 qualified investment less zero recomputed qualified investment).

[T.D. 6731, 29 FR 6068, May 8, 1964, as amended by T.D. 6931, 32 FR 14026, Oct. 10, 1967; T.D. 7203, 37 FR 17125, Aug. 25, 1972; T.D. 7602, 44 FR 17667, Mar. 23, 1979]

§ 1.46-4 Limitations with respect to certain persons.

(a) *Mutual savings institutions.* In the case of an organization to which section 593 applies (that is, a mutual savings bank, a cooperative bank, or a domestic building and loan association)—

(1) The qualified investment with respect to each section 38 property shall be 50 percent of the amount otherwise determined under § 1.46-3, and

(2) The $25,000 amount specified in section 46(a)(2), relating to limitation based on amount of tax, shall be reduced by 50 percent of such amount.

For example, if a domestic building and loan association places in service on January 1, 1963, new section 38 property with a basis of $30,000 and an estimated useful life of 6 years, its qualified investment for 1963 with respect to such property computed under § 1.46-3 is $20,000 (66⅔ percent of $30,000). However, under this paragraph such amount is reduced to $10,000 (50 percent of $20,000). If an organization to which section 593 applies is a member of an affiliated group (as defined in section 46(a)(5)), the $25,000 amount specified in section 46(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of § 1.46-1 before such amount is further reduced under this paragraph.

(b) *Regulated investment companies and real estate investment trusts.* (1) In the case of a regulated investment company or a real estate investment trust subject to taxation under subchapter M, chapter 1 of the Code—

(i) The qualified investment with respect to each section 38 property otherwise determined under § 1.46-3, and

(ii) The $25,000 amount specified in section 46(a)(2), relating to limitation based on amount of tax,

shall be reduced to such person's ratable share of each such amount. If a regulated investment company or a real estate investment trust is a member of an affiliated group (as defined in section 46(a)(5)), the $25,000 amount specified in section 46(a)(2)

shall be reduced in accordance with the provisions of paragraph (f) of § 1.46-1 before such amount is further reduced under this paragraph.

(2) A person's ratable share of the amount described in subparagraph (1)(i) and the amount described in subparagraph (1)(ii) of this paragraph shall be the ratio which—

(i) Taxable income for the taxable year, bears to

(ii) Taxable income for the taxable year plus the amount of the deduction for dividends paid taken into account under section 852(b)(2)(D) in computing investment company taxable income, or under section 857(b)(2)(B) (section 857(b)(2)(C), as then in effect, for taxable years ending before October 5, 1976) in computing real estate investment trust taxable income, as the case may be.

For purposes of the preceding sentence, taxable income means, in the case of a regulated investment company its investment company taxable income (within the meaning of section 852(b)(2)), and in the case of a real estate investment trust its real estate investment trust taxable income (within the meaning of section 857(b)(2)). In the case of a taxable year ending after October 4, 1976, real estate investment trust taxable income, for purposes of section 46(e) and this paragraph, is determined by excluding any net capital gain, and by computing the deduction for dividends paid without regard to capital gains dividends (as defined in section 857(b)(3)(C)). In the case of a real estate investment trust, the amount of the deduction for dividends paid includes the amount of deficiency dividends (other than capital gains deficiency dividends) taken into account in computing real estate investment trust taxable income for the taxable year. See section 859(d) for the definition of deficiency dividends. For purposes of this paragraph only, in computing taxable income for a taxable year beginning before January 1, 1964, a regulated investment company or a real estate investment trust may compute depreciation deductions with respect to section 38 property placed in service before January 1, 1964, without regard to the reduction in basis of such property required under § 1.48-7.

(3) This paragraph may be illustrated by the following example:

Example. (i) Corporation X, a regulated investment company subject to taxation under section 852 of the Code which makes its return on the basis of the calendar year, places in service on January 1, 1964, section 38 property with a basis of $30,000 and an estimated useful life of 6 years. Corporation X's investment company taxable income under section 852(b)(2) is $10,000 after taking into account a deduction for dividends paid of $90,000.

(ii) Under this paragraph, corporation X's qualified investment for the taxable year 1964 with respect to such property is $2,000, computed as follows: (*a*) $20,000 (qualified investment under § 1.46-3), multiplied by (*b*) $10,000 (taxable income), divided by (*c*) $100,000 (taxable income plus the deduction for dividends paid). For 1964, the $25,000 amount specified in section 46(a)(2) is reduced to $2,500.

(c) *Cooperatives.* (1) In the case of a cooperative organization described in section 1381(a)—

(i) The qualified investment with respect to each section 38 property otherwise determined under § 1.46-3, and

(ii) The $25,000 amount specified in section 46(a)(2), relating to limitation based on amount of tax,

shall be reduced to such cooperative's ratable share of each such amount. If a cooperative organization described in section 1381(a) is a member of an affiliated group (as defined in section 46(a)(5)), the $25,000 amount specified in section 46(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of § 1.46-1 before such amount is further reduced under this paragraph.

(2) A cooperative's ratable share of the amount described in subparagraph (1)(i) and the amount described in subparagraph (1)(ii) of this paragraph shall be the ratio which—

(i) Taxable income for the taxable year, bears to

(ii) Taxable income for the taxable year plus the sum of (*a*) the amount of the deductions allowed under section 1382(b), (*b*) the amount of the deductions allowed under section 1382(c), and (*c*) amounts similar to the amounts described in (*a*) and (*b*) of

this subdivision the tax treatment of which is determined without regard to subchapter T, chapter 1 of the Code and the regulations thereunder.

Amounts similar to deductions allowed under section 1382 (b) or (c) are, for example, in the case of a taxable year of a cooperative organization beginning before January 1, 1963, the amount of patronage dividends which are excluded or deducted and any nonpatronage distributions which are deducted under section 522(b)(1). In the case of a taxable year of a cooperative organization beginning after December 31, 1962, such amounts are the amount of patronage dividends and nonpatronage distributions which are excluded or deducted without regard to section 1382 (b) or (c) because they are paid with respect to patronage occurring before 1963. For purposes of this paragraph only, in computing taxable income for a taxable year beginning before January 1, 1964, a cooperative may compute depreciation deductions with respect to section 38 property placed in service before January 1, 1964, without regard to the reduction in basis of such property required under § 1.48-7.

(3) This paragraph may be illustrated by the following example:

Example. (i) Cooperative X, an organization described in section 1381(a) which makes its return on the basis of the calendar year, places in service on January 1, 1964, section 38 property with a basis of $30,000 and an estimated useful life of 6 years. Cooperative X's taxable income is $10,000 after taking into account deductions of $20,000 allowed under section 1382(b), deductions of $60,000 allowed under section 1382(c), and deductions of $10,000 allowed under section 522(b)(1)(B).

(ii) Under this paragraph, cooperative X's qualified investment for the taxable year 1964 with respect to such property is $2,000, computed as follows: (*a*) $20,000 (qualified investment under § 1.46-3), multiplied by (*b*) $10,000 (taxable income), divided by (*c*) $100,000 (taxable income plus the sum of the deductions allowed under sections 1382(b), 1382(c), and 522(b)(1)(B)). For 1964, the $25,000 amount specified in section 46(a)(2) is reduced to $2,500.

(d) *Noncorporate lessors.* (1) In the case of a lease entered into after September 22, 1971, a credit is allowed under section 38 to a noncorporate lessor of property with respect to the leased property only if—

(i) Such property has been manufactured or produced by the lessor in the ordinary course of his business, or

(ii) The term of the lease (taking into account any options to renew) is less than 50 percent of the estimated useful life of the property (determined under § 1.46-3(e)), and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.

In the case of property of which a partnership is the lessor, the credit otherwise allowable under section 38 with respect to such property to any partner which is a corporation shall be allowed notwithstanding the first sentence of this subparagraph. For purposes of this subparagraph, an electing small business corporation (as defined in section 1371) shall be treated as a person which is not a corporation. This paragraph shall not apply to property used by the taxpayer in his trade or business (other than the leasing of property) for a period of at least 24 months preceding the day on which any lease of such property is entered into.

(2) For purposes of subparagraph (1)(ii) of this paragraph, if at the time the lessor files his income tax return for the taxable year in which the property is placed in service, the lessor is unable to show that the more-than-15-percent test has been satisfied, then no credit may be claimed by the lessor on such return with respect to such property unless (i) taking into account the lessor's obligations under the lease it is reasonable to believe that the more-than-15-percent test will be satisfied, and (ii) the lessor files a statement with his return from which it may be determined that he expects to satisfy the more-than-15-percent test. If the more-than-15-percent test is not satisfied with respect to the property, the taxpayer must file an amended

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return for the year in which the property is placed in service.

(3)(i) The more-than-15-percent test described in subparagraph (1)(ii) of this paragraph is based on the relationship of the expenses of the lessor relating to or attributable to the property to the gross income from rents of the taxpayer produced by the property. The test is applied with respect to such expenses and gross income as are properly attributable to the period consisting of the first 12 months after the date on which the property is transferred to the lessee. When more than one property is subject to a single lease and, pursuant to subparagraph (4) of this paragraph, the arrangement is considered to be a separate lease of each property, the test is applied separately to each such lease by making an apportionment of the payments received and expenses incurred with respect to each such property, considering all relevant factors. Such apportionment is made in accordance with any reasonable method selected and consistently applied by the taxpayer. For example, under subparagraph (4) of this paragraph, where a taxpayer leases an airplane which he owns to an airline along with a baggage truck, he is treated as having made two separate leases, one covering the airplane and one covering the baggage truck. Thus, the test will be applied by apportioning the related income and expenses between the two leases. Similarly, where a taxpayer leases a factory building erected by him containing section 38 property (machinery and equipment), the test will be applied to the taxpayer as though he had leased (to the lessee) the building and the section 38 property separately. Thus, the rental income and expenses are apportioned between the building and the section 38 property.

(ii) Only those deductions allowable solely by reason of section 162 are taken into account in applying the more-than-15-percent test. Hence, depreciation allowable by reason of section 167 (including amortization allowable in lieu of depreciation); interest allowable by reason of section 163; taxes allowable by reason of section 164; and depletion allowable by reason of section 611 are examples of deductions which are not taken into account in applying the test. Moreover, rents and reimbursed amounts paid or payable by the lessor are not taken into account notwithstanding that a deduction in respect of such rents or reimbursed amounts is allowable solely by reason of section 162. For purposes of this paragraph, a reimbursed amount is any expense for which the lessee or some other party is obligated to reimburse the lessor. Section 162 expenses paid or payable by any person other than the lessor are not taken into account unless the lessor is obligated to reimburse the person paying the expense. Further, if the lessee is obligated to pay to the lessor a charge for services which is separately stated or determinable, the expenses incurred by the lessor with respect to those services are not taken into account.

(iii) For purposes of the more-than-15-percent test, the gross income from rents of the lessor produced by the property is the total amount which is payable to the lessor by reason of the lease agreement other than reimbursements of section 162 expenses and charges for services which are separately stated or determinable. The fact that such amount depends, in whole or in part, on the sales or profits of the lessee or the performance of significant services by the lessor shall not affect the characterization of such amounts as gross income from rents for purposes of this paragraph. Gross income from rents also includes any taxes imposed on the lessor by local law but which are paid directly by the lessee on behalf of the lessor.

(4) For purposes of determining under this paragraph whether property is subject to a lease, the provisions of § 1.57-3(d)(1) (relating to definition of a lease) shall apply. If a noncorporate lessor enters into two or more successive leases with respect to the same or substantially similar items of section 38 property, the terms of such leases shall be aggregated and such leases shall be considered one lease for the purpose of determining whether the term of such leases is less than 50 percent of the estimated useful life of the property subject to such leases. Thus, for example, if an individual

owns an airplane with an estimated useful life of 7 years and enters into three successive 3-year leases of such airplane, such leases will be considered to be one lease for a term of nine years for the purpose of determining whether the term of the lease is less than 3½ years (50 percent of the 7-year estimated useful life).

[T.D. 6731, 29 FR 6071, May 8, 1964, as amended by T.D. 6958, 33 FR 9170, June 21, 1968; T.D. 7203, 37 FR 17126, Aug. 25, 1972; T.D. 7767, 46 FR 11262, Feb. 6, 1981]

§ 1.46-6 Limitation in case of certain regulated companies.

(a) *In general*—(1) *Scope of section.* This section does not reflect amendments made to section 46 after enactment of the Revenue Act of 1971, other than the redesignation of section 46(e) as section 46(f) by the Tax Reduction Act of 1975.

(2) *Disallowance of credit.* Under section 46(f), a credit otherwise allowable under section 38 ("credit") will be disallowed in certain cases with respect to "section 46(f) property" as defined in paragraph (b)(1) of this section. Paragraph (f) of this section describes circumstances under which a determination put into effect by a regulatory body will result in the disallowance of the credit. Such a determination will result in a disallowance only if section 46(f) (1) or (2) applies to such property and such determination affects the taxpayer's cost of service or rate base in a manner inconsistent with section 46(f) (1) or (2) (whichever is applicable).

(3) *General rules.* The provisions of section 46(f) (1) and (2) are limitations on the treatment of the credit for ratemaking purposes and for purposes of the taxpayer's regulated books of account only. Under the provisions of section 46(f)(1), the credit may not be flowed through to income (*i.e.*, used to reduce taxpayer's cost of service) but in certain circumstances may be used to reduce rate base (provided that such reduction is restored not less rapidly than ratably). If an election is made under section 46(f)(2), the credit may be flowed through to income (but not more rapidly than ratably) and there may not be any reduction in rate base. If an election is made under section 46(f)(3), none of the limitations of section 46(f) (1) or (2) apply to certain section 46(f) property of the taxpayer. Thus, under the provisions of section 46(f)(3), no credit is disallowed if the credit is treated in any manner for ratemaking purposes, including any manner of treatment permitted under the limitations of section 46(f) (1) or (2).

(4) *Elections.* For rules relating to the manner of making, on or before March 9, 1972, the three elections listed in section 46(f) (1), (2), and (3), see 26 CFR 12.3. For rules relating to the application of such elections, see paragraph (h) of this section.

(5) *Cross references.* For rules with respect to the treatment of corporate reorganizations, asset acquisitions, and taxpayers subject to the jurisdiction of more than one regulatory body, etc., see paragraph (j) of this section.

(6) *Nonapplication of prior law.* Under section 105 (e) of the Revenue Act of 1971, section 203 (e) of the Revenue Act of 1964, 78 Stat. 35, does not apply to section 46(f) property.

(b) *Definitions.* For purposes of this section, the following definitions apply:

(1) *Section 46(f) property.* "Section 46(f) property" is property described in section 50 that is—

(i) Public utility property within the meaning of section 46(c)(3)(B) (other than nonregulated communication property described in § 1.46-3(g)(2)(iv)) or

(ii) Property used predominantly in the trade or business of the furnishing or sale of steam through a local distribution system or of the transportation of gas or steam by pipeline, if the rates for the trade or business are regulated within the meaning of § 1.46-3(g)(2)(iii).

For purposes of determining whether property is used predominantly in the trade or business of transportation of gas by pipeline (or of transportation of gas by pipeline and of furnishing or sale of gas through a local distribution system), the rules prescribed in § 1.46-3(g)(4) apply except that accounts 365 through 371 inclusive (Transmission Plant) are added to the accounts listed in § 1.46-3(g)(4)(i).

(2) *Cost of service.* (i) For purposes of this section, "cost of service" is the amount required by a taxpayer to provide regulated goods or services. Cost of service includes operating expenses (including salaries, cost of materials, etc.) maintenance expenses, depreciation expenses, tax expenses, and interest expenses. For purposes of this section, any effect on a taxpayer's permitted return on investment that results from a reduction in the taxpayer's rate base does not constitute a reduction in cost of service, even though, as a technical ratemaking term, "cost of service" ordinarily includes a permitted return on investment.

(ii) In determining whether, or to what extent, a credit has been used to reduce cost of service, reference shall be made to any accounting treatment that affects cost of service. Examples of such treatment include reducing by all or a portion of the credit the amount of Federal income tax expense taken into account for ratemaking purposes and reducing the depreciable bases of property by all or a portion of the credit for ratemaking purposes.

(3) *Rate base.* (i) For purposes of this section, "rate base" is the monetary amount that is multiplied by a rate of return to determine the permitted return on investment.

(ii) In determining whether, or to what extent, a credit has been used to reduce rate base, reference shall be made to any accounting treatment that affects rate base. In addition, in those cases in which the rate of return is based on the taxpayer's cost of capital, reference shall be made to any accounting treatment that affects the permitted return on investment by treating the credit in any way other than as though it were capital supplied by common shareholders to which a "cost of capital" rate is assigned that is not less than the taxpayer's overall cost of capital rate (determined without regard to the credit). What is the overall cost of capital rate depends upon the practice of the regulatory body. Thus, for example, an overall cost of capital rate may be a rate determined on the basis of an average, or weighted average, of the costs of capital provided by common shareholders, preferred shareholders and creditors.

(4) *Indirect reductions to cost of service or rate base.* (i) Cost of service or rate base is also considered to have been reduced by reason of all or a portion of a credit if such reduction is made in an indirect manner.

(ii) One type of such an indirect reduction is any ratemaking decision in which the credit is treated as operating income (subject to ratemaking regulation) or as capital provided by anyone other than common shareholders. For example, if a credit is accounted for as nonoperating income on a company's regulated books of account but a ratemaking decision has the effect of treating the credit as operating income in determining rate of return to common shareholders, then cost of service has been indirectly reduced by reason of the credit.

(iii) A second type of indirect reduction is any ratemaking decision intended to achieve an effect similar to a direct reduction to cost of service or rate base. In determining whether a ratemaking decision is intended to achieve this effect, consideration is given to all the relevant facts and circumstances of each case, including, but not limited to—

(A) The record of the proceeding,

(B) The regulatory body's orders or opinions (including any dissenting views), and

(C) The anticipated effect of the ratemaking decision on the company's revenues in comparison to a direct reduction to cost of service or rate base by reason of the investment tax credits available to the regulated company.

(iv) This paragraph (b)(4)(iv) describes a situation that is not an indirect reduction to cost of service or rate base by reason of all or a portion of a credit. The ratemaking treatment of credits may affect the financial condition of a company, including the company's ability to attract new capital, the cost of that capital, the company's future financial requirements, the market price of the company's securities, and the degree of risk attributable to investment in those securities. The financial condition may be reflected in certain customary financial indicators such as the comparative

capital structure of the company, coverage ratios, price/earnings ratios, and price/book ratios. Under the facts and circumstances test of paragraph (b)(4)(iii) of this section, the consideration of a company's financial condition by a regulatory body is not an indirect reduction to cost of service or rate base, even though such condition, as affected by the ratemaking treatment of the company's investment tax credits, is considered in the development of a reasonable rate of return on common shareholders' investment.

(c) *General rule*—(1) *In general.* Section 46(f)(1) applies to all of the taxpayer's section 46(f) property except property to which an election under section 46(f) (2) or (3) applies. Under section 46(f)(1), the credit for the taxpayer's section 46(f) property will be disallowed if—

(i) The taxpayer's cost of service for ratemaking purposes is reduced by reason of any portion of such credit, or

(ii) The taxpayer's rate base is reduced by reason of any portion of the credit and such reduction in rate base is not restored or is restored less rapidly than ratably within the meaning of paragraph (g) of this section.

(2) *Insufficient natural domestic supply.* The provisions of paragraph (c)(1)(ii) of this section shall not apply to permit any reduction in taxpayer's rate base with respect to its "short supply property" if it made an election under the last sentence of section 46(f)(1) on or before March 9, 1972.

(3) *Short supply property.* For purposes of this section, section 46(f) property is "short supply property" if—

(i) The property is described in paragraph (b)(1)(ii) of this section,

(ii) The regulatory body described in section 46(c)(3)(B) that has jurisdiction for ratemaking purposes with respect to such trade or business is an agency or instrumentality of the United States, and

(iii) This regulatory body makes a short supply determination and the determination is in effect on the date such property is placed in service.

(4) *Short supply determination.* A short supply determination is made or revoked on the date of its publication in the FEDERAL REGISTER. It is a determination that the natural domestic supply of gas or steam is insufficient to meet the present and future requirements of the domestic economy.

(5) *Dates short supply determination in effect.* (i) A short supply determination is considered to be in effect with respect to section 46(f) property placed in service at any time before the determination is revoked. However, a short supply determination made after June 20, 1979 is not considered to be in effect with respect to section 46(f) property placed in service before such determination was made.

(d) *Special rule for ratable flow-through.* If an election was made under section 46(f)(2) on or before March 9, 1972, section 46(f)(2) applies to all of the taxpayer's section 46(f) property except property to which an election under section 46(f)(3) applies. Under section 46(f)(2), the credit for the taxpayer's section 46(f) property will be disallowed if—

(1) The taxpayer's cost of service, for ratemaking purposes or in its regulated books of account, is reduced by more than a ratable portion of such credit within the meaning of paragraph (g) of this section or

(2) The taxpayer's rate base is reduced by reason of any portion of such credit.

(e) *Flow-through property.* If a taxpayer made an election under section 46(f)(3) on or before March 9, 1972, section 46(f) (1) and (2) do not apply to the taxpayer's section 46(f) property to which section 167(l)(2)(C) applies. In the case of an election under section 46(f)(3), a credit will not be disallowed, notwithstanding a determination by a regulatory body having jurisdiction over such taxpayer that reduces the taxpayer's cost of service or rate base by reason of such credit. In general, section 167(l)(2)(C) applies to property with respect to which a taxpayer may use a flow-through method of accounting (within the meaning of section 167(l)(3)(H)) to take into account the allowance for depreciation under section 167(a). Section 167(l)(2)(C) applies to property even though the taxpayer does not use a flow-through method of accounting with respect to the property. Section

167(l)(2)(C) does not apply to property if the taxpayer can not use a flow-through method of accounting with respect to the property. For example, section 167(l)(2)(C) does not apply to property with respect to which an election under section 167(l)(4)(A) applies. Thus, such property does not qualify for an election under section 46(f)(3).

(f) *Limitations*—(1) *In general.* This paragraph provides rules relating to limitations on the disallowance of credits under section 46(f)(4). Key terms are defined in paragraphs (f)(7), (8), and (9) of this section.

(2) *Disallowance postponed.* There is no disallowance of a credit before the first final inconsistent determination is put into effect for the taxpayer's section 46(f) property.

(3) *Time of disallowance.* A credit is disallowed—

(i) When the first final inconsistent determination is put into effect and

(ii) When any inconsistent determination (whether or not final) is put into effect after the first final inconsistent determination is put into effect.

(4) *Credits disallowed.* A credit is disallowed for section 46(f) property placed in service (within the meaning of § 1.46-3(d)) by the taxpayer—

(i) Before the date any inconsistent determination described in paragraph (f)(2) of this section is put into effect and

(ii) On or after such date and before the date a subsequent consistent determination (whether or not final) is put into effect.

(5) *Barred years.* No amount of credit for a taxable year is disallowed under paragraph (f)(3) of this section if, for such year, assessment of a deficiency is barred by any law or rule of law.

(6) *Notification and other requirements.* The taxpayer shall notify the district director of a disallowance of a credit under paragraph (f)(3) of this section within 30 days of the date that the applicable determination is put into effect. In the case of such a disallowance, the taxpayer shall recompute its tax liability for any affected taxable year, and such recomputation shall be made in the form of an amended return where necessary.

(7) *Determinations.* For purposes of this paragraph, the term "determination" refers to a determination made with respect to section 46(f) property (other than property to which an election under section 46(f)(3) applies) by a regulatory body described in section 46(c)(3)(B) that determines the effect of the credit—

(i) For purposes of section 46(f)(1), on the taxpayer's cost of service or rate base for ratemaking purposes or

(ii) In the case of a taxpayer that made an election under section 46(f)(2), on the taxpayer's cost of service, for ratemaking purposes or in its regulated books of account, or on the taxpayer's rate base for ratemaking purposes.

A regulatory body does not have to take affirmative action to make a determination. Thus, a regulatory body's failure to take action on a rate schedule filed by a taxpayer is a determination if the rates can be put into effect without further action by the regulatory body.

(8) *Types of determinations.* For purposes of this paragraph—

(i) The term "inconsistent" refers to a determination that is inconsistent with section 46(f)(1) or (2) (as the case may be). Thus, for example, a determination to reduce the taxpayer's cost of service by more than a ratable portion of the credit would be a determination that is inconsistent with section 46(f)(2). As a further example, such a determination would also be inconsistent if section 46(f)(1) applied because no reduction in cost of service is permitted under section 46(f)(1).

(ii) The term "consistent" refers to a determination that is consistent with section 46(f)(1) or (2) (as the case may be).

(iii) The term "final determination" means a determination with respect to which all rights to appeal or to request a review, a rehearing, or a redetermination have been exhausted or have lapsed.

(iv) The term "first final inconsistent determination" means the first final determination put into effect after December 10, 1971, that is incon-

sistent with section 46(f) (1) or (2) (as the case may be).

(9) *Put into effect.* A determination is put into effect on the latter of—

(i) The date it is issued (or, if a first final inconsistent determination, the date it becomes final) or

(ii) The date it becomes operative.

(10) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). Corporation X, a calendar-year taxpayer engaged in a public utility activity is subject to the jurisdiction of regulatory body A. On September 15, 1971, X purchases section 46(f) property and places it in service on that date. For 1971, X takes the credit allowable by section 38 with respect to such property. X does not make any election permitted by section 46(f). On October 9, 1972, A makes a determination that X must account for the credit allowable under section 38 in a manner inconsistent with section 46(f)(1). The determination, which was the first determination by A after December 10, 1971, becomes final on January 1, 1973, and holds that X must retroactively adjust the manner in which it accounted for the credit allowable under section 38 starting with the taxable year that began on January 1, 1972. Since, under the provisions of paragraph (f)(8) of this section, the determination by A is put into effect on January 1, 1973 (the date it becomes final), the credit is retroactively disallowed with respect to any of X's section 46(f) property placed in service before January 1, 1973, on any date which occurs during a taxable year with respect to which an assessment of a deficiency has not been barred by any law or rule of law. In addition, the credit is disallowed with respect to X's section 46(f) property placed in service on or after January 1, 1973, and before the date that a subsequent determination by A, which as to X is consistent with section 46(f)(1), is put into effect. Thus, X must amend its income tax return for 1971 to reflect the retroactive disallowance of the credit otherwise allowable under section 38 with respect to the section 46(f) property placed in service on September 15, 1971.

Example (2). The facts are the same as in example (1), except that the first inconsistent determination by A becomes final on April 5, 1972, and requires X to account for the credit for all taxable years beginning on or after January 1, 1973, in a manner inconsistent with section 46(f)(1). Under the provisions of paragraph (f)(8) of this section, the determination was put into effect on January 1, 1973 (the date it became operative). The result is the same as in example (1).

Example (3). The facts are the same as in example (1), except that on June 1, 1975, A issues a determination that X shall retroactively account for the credit allowable by section 38 in a manner consistent with the provisions of section 46(f)(1) for taxable years beginning on or after January 1, 1971. The determination becomes final on January 5, 1976, in the same form as originally issued. The result is the same as in example (1) with respect to property X places in service before June 1, 1975. The credit is allowed with respect to property X places in service on or after June 1, 1975 (the date that the consistent determination is put into effect).

(g) *Ratable methods*—(1) *In general.* Under this paragraph (g), rules are prescribed for purposes of determining whether or not, under section 46(f)(1), a reduction in the taxpayer's rate base with respect to the credit is restored less rapidly than ratably and whether or not under section 46(f)(2) the taxpayer's cost of service for ratemaking purposes is reduced by more than a ratable portion of such credit.

(2) *Regulated depreciation expense.* What is "ratable" is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. "Regulated depreciation expense" is the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes. Such period of time shall be expressed in units of years (or shorter periods), units of production, or machine hours and shall be determined in accordance with the individual useful life system or composite (or other group asset) account system actually used in computing the taxpayer's regulated depreciation expense. A method of restoring, or reducing, is ratable if the amount to be restored to rate base, or to reduce cost of service (as the case may be), is allocated ratably in proportion to the number of such units. Thus, for example, assume that the regulated depreciation expense is computed under the straight line method by applying a composite annual percentage rate to "original cost" (as defined for purposes of computing regulated depreciation expense). If, with respect to an item of

section 46(f) property, the amount to be restored annually to rate base is computed by applying a composite annual percentage rate to the amount by which the rate base was reduced, then the restoration is ratable. Similarly, if cost of service is reduced annually by an amount computed by applying a composite annual percentage rate to the amount of the credit, cost of service is reduced by a ratable portion. If such composite annual percenage rate were revised for purposes of computing regulated depreciation expense beginning with a particular accounting period, the computation of ratable restoration or ratable portion (as the case may be) must also be revised beginning with such period. A composite annual percentage rate is determined solely by reference to the period of time actually used by the taxpayer in computing its regulated depreciation expense without reduction for salvage or other items such as over and under accruals. A composite annual percentage rate determined by taking into account salvage value or other items shall be considered to be ratable in the case of a determination (whether or not final) issued before March 22, 1979, and any rate order (whether or not final) that is entered into before June 20, 1979, in response to a rate case filed before April 23, 1979. For this purpose, the term "rate order" does not include an order by a regulatory body that perfunctorily adopts rates as filed if such rates are suspended or subject to rebate.

(h) *Elections*—(1) *Applicability of elections.* (i) Any election under section 46(f) applies to all of the taxpayer's property eligible for the election, whether or not the taxpayer is regulated by more than one regulatory body.

(ii) Section 46(f)(1) applies to all of the taxpayer's section 46(f) property in the absence of an election under either section 46(f) (2) or (3). If an election is made under section 46(f)(2), section 46(f)(1) does not apply to any of the taxpayer's section 46(f) property.

(iii) An election made under the last sentence of section 46(f)(1) applies to that portion of the taxpayer's section 46(f) property to which section 46(f)(1) applies and which is short supply property within the meaning of paragraph (c)(2) of this section.

(iv) If a taxpayer makes an election under section 46(f)(2) and makes no election under section 46(f)(3), the election under section 46(f)(2) applies to all of the taxpayer's section 46(f) property.

(v) If a taxpayer makes an election under section 46(f)(3), such election applies to all of the taxpayer's section 46(f) property to which section 167(l)(2)(C) applies. Section 46(f) (1) or (2) (as the case may be) applies to that portion of the taxpayer's section 46(f) property that is not property to which section 167(f)(2)(C) applies. Thus, for example, if a taxpayer makes an election under section 46(f)(2) and also makes an election under section 46(f)(3), section 46(f)(3) applies to all of the taxpayer's section 46(f) property to which section 167(l)(2)(C) applies, and section 46(f)(2) applies to the remainder of the taxpayer's section 46(f) property.

(2) *Method of making elections.* See 26 CFR 12.3 for rules relating to the method of making the elections described in section 46(f) (1), (2), or (3).

(i) [Reserved]

(j) *Reorganizations, asset acquisitions, multiple regulation, etc.*—(1) *Taxpayers not entirely subject to jurisdiction of one regulatory body.* (i) If a taxpayer is required by a regulatory body having jurisdiction over less than all of its property to account for the credit under a determination that is inconsistent with section 46(f) (1) or (2) (as the case may be), such credit shall be disallowed only with respect to property subject to the jurisdiction of such regulatory body.

(ii) For purposes of this paragraph (j), a regulatory body is considered to have jurisdiction over property of a taxpayer if the property is included in the rate base for which the regulatory body determines an allowable rate of return for ratemaking purposes or if expenses with respect to the property are included in cost of service as determined by the regulatory body for ratemaking purposes. For example, if regulatory body A, having jurisdiction over 60 percent of an item of corporation X's section 46(f) property, makes

a determination which is inconsistent with section 46(f), and if regulatory body B, having jurisdiction over the remaining 40 percent of such item of property, makes a consistent determination (or if the remaining 40 percent is not subject to the jurisdiction of any regulatory body), then 60 percent of the credit for such item will be disallowed. For a further example, if regulatory body A, having jurisdiction over 60 percent of X's section 46(f) property, has jurisdiction over 100 percent of a particular generator, 100 percent of the credit for such generator will be disallowed.

(iii) For rules which provide that the 3 elections under section 46(f) may not be made with respect to less than all of the taxpayer's property eligible for the election, see paragraph (h)(1)(i) of this section.

[T.D. 7602, 44 FR 17668, Mar. 23, 1979]

§ 1.46-7 Statutory provisions; plan requirements for taxpayers electing additional investment credit, etc.

As amended by sections 802(b)(7), and 803 (c), (d), and (e) of the Tax Reform Act of 1976 (90 Stat. 1520), section 301 (d), (e), and (f) of the Tax Reduction Act of 1975 (89 Stat. 38) provides as follows:

Sec. 301. Increase in investment credit.
• • •

(d) *Plan requirements for taxpayers electing additional credit.* In order to meet the requirements of this subsection—

(1) Except as expressly provided in subsections (e) and (f), a corporation (hereinafter in this subsection referred to as the "employer") must establish an employee stock ownership plan (described in paragraph (2)) which is funded by transfers of employer securities in accordance with the provisions of paragraph (6) and which meets all other requirements of this subsection.

(2) The plan referred to in paragraph (1) must be a defined contribution plan established in writing which—

(A) Is a stock bonus plan, a stock bonus and a money purchase pension plan, or a profit-sharing plan,

(B) Is designed to invest primarily in employer securities, and

(C) Meets such other requirements (similar to requirements applicable to employee stock ownership plans as defined in section 4975(e)(7) of the Internal Revenue Code of 1954) as the Secretary of the Treasury or his delegate may prescribe.

(3) The plan must provide for the allocation of all employer securities transferred to it or purchased by it (because of the requirements of section 46(a)(2)(B) of the Internal Revenue Code of 1954) to the account of each participant (who was a participant at any time during the plan year, whether or not he is a participant at the close of the plan year) as of the close of each year in an amount which bears substantially the same proportion to the amount of all such securities allocated to all participants in the plan for that plan year as the amount of compensation paid to such participant (disregarding any compensation in excess of the first $100,000) bears to the compensation paid to all such participants during that year (disregarding any compensation in excess of the first $100,000 with respect to any participant). Notwithstanding the first sentence of this paragraph, the allocation to participants' accounts may be extended over whatever period may be necessary to comply with the requirements of section 415 of the Internal Revenue Code of 1954. For purposes of this paragraph, the amount of compensation paid to a participant for a year is the amount of such participant's compensation within the meaning of section 415(c)(3) of such Code for such year.

(4) The plan must provide that each participant has a nonforfeitable right to any stock allocated to his account under paragraph (3), and that no stock allocated to a participant's account may be distributed from that account before the end of the eighty-fourth month beginning after the month in which the stock is allocated to the account except in the case of separation from the service, death, or disability.

(5) The plan must provide that each participant is entitled to direct the plan as to the manner in which any employer securities allocated to the account of the participant are to be voted.

(6) On making a claim for credit, adjustment, or refund under section 38 of the Internal Revenue Code of 1954, the employer states in such claim that it agrees, as a condition of receiving any such credit, adjustment, or refund—

(A) In the case of a taxable year beginning before January 1, 1977, to transfer employer securities forthwith to the plan having an aggregate value at the time of the claim of 1 percent of the amount of the qualified investment (as determined under section 46 (c) and (d) of such Code) of the taxpayer for the taxable year, and

(B) In the case of a taxable year beginning after December 31, 1976—

(i) To transfer employer securities to the plan having an aggregate value at the time of the claim of 1 percent of the amount of the qualified investment (as determined

under section 46 (c) and (d) of such Code) of the employer for the taxable year,

(ii) Except as provided in clause (iii), to effect the transfer not later than 30 days after the time (including extensions) for filing its income tax return for a taxable year, and

(iii) In the case of an employer whose credit (as determined under section 46 (a)(2)(B) of such Code) for a taxable year beginning after December 31, 1976, exceeds the limitations of paragraph (3) of section 46(a) of such Code—

(I) To effect that portion of the transfer allocable to investment credit carrybacks of such excess credit at the time required under clause (ii) for the unused credit year (within the meaning of section 46(b) of such Code), and

(II) To effect that portion of the transfer allocable to investment credit carryovers of such excess credit at the time required under clause (ii) for the taxable year to which such portion is carried over.

For purposes of meeting the requirements of this paragraph, a transfer of cash shall be treated as a transfer of employer securities if the cash is, under the plan, used to purchase employer securities.

(7) Notwithstanding any other provisions of law to the contrary, if the plan does not meet the requirements of section 401 of the Internal Revenue Code of 1954—

(A) Stock transferred under paragraph (6) or subsection (e)(3) and allocated to the account of any participant under paragraph (3) and dividends thereon shall not be considered income of the participant or his beneficiary under the Internal Revenue Code of 1954 until actually distributed or made available to the participant or his beneficiary and, at such time, shall be taxable under section 72 of such Code (treating the participant or his beneficiary as having a basis of zero in the contract).

(B) No amount shall be allocated to any participant in excess of the amount which might be allocated if the plan met the requirements of section 401 of such Code, and

(C) The plan must meet the requirements of sections 410 and 415 of such Code.

(8)(A) Except as provided in subparagraph (B)(iii), if the amount of the credit determined under section 46(a)(2)(B) of the Internal Revenue Code of 1954 is recaptured or redetermined in accordance with the provisions of such Code, the amounts transferred to the plan under this subsection and subsection (e) and allocated under the plan shall remain in the plan or in participant accounts, as the case may be, and continue to be allocated in accordance with the plan.

(B) If the amount of the credit determined under section 46(a)(2)(B) of the Internal Revenue Code of 1954 is recaptured in accordance with the provisions of such Code—

(i) The employer may reduce the amount required to be transferred to the plan under paragraph (6) of this subsection, or under paragraph (3) of subsection (e), for the current taxable year or any succeeding taxable years by the portion of the amount so recaptured which is attributable to the contribution to such plan,

(ii) Notwithstanding the provisions of paragraph (12), the employer may deduct such portion, subject to the limitations of section 404 of such Code (relating to deductions for contributions to an employees' trust or plan), or

(iii) If the requirements of subsection (f)(1) are met, the employer may withdraw from the plan an amount not in excess of such portion.

(C) If the amount of the credit claimed by an employer for a prior taxable year under section 38 of the Internal Revenue Code of 1954 is reduced because of a redetermination which becomes final during the taxable year, and the employer transferred amounts to a plan which were taken into account for purposes of this subsection for that prior taxable year, then—

(i) The employer may reduce the amount it is required to transfer to the plan under paragraph (6) of this subsection, or under paragraph (3) of subsection (e), for the taxable year or any succeeding taxable year by the portion of the amount of such reduction in the credit or increase in tax which is attributable to the contribution to such plan, or

(ii) Notwithstanding the provisions of paragraph (12), the employer may deduct such portion subject to the limitations of section 404 of such Code.

(9) For purposes of this subsection, the term—

(A) "Employer securities" means common stock issued by the employer or a corporation which is a member of a controlled group of corporations which includes the employer (within the meaning of section 1563(a) of the Internal Revenue Code of 1954, determined without regard to section 1563(a)(4) and (e)(3)(C) of such Code) and with voting power and dividend rights no less favorable than the voting power and dividend rights of other common stock issued by the employer or such controlling corporation, or securities issued by the employer or such controlling corporation, convertible into such stock, and

(B) "Value" means the average of closing prices of the employer's securities, as reported by a national exchange on which securities are listed, for the 20 consecutive trading days immediately preceding the date of transfer or allocation of such securities or, in the case of securities not listed on

a national exchange, the fair market value as determined in good faith and in accordance with regulations issued by the Secretary of the Treasury or his delegate.

(10) The Secretary of the Treasury or his delegate shall prescribe such regulations and require such reports as may be necessary to carry out the provisions of this subsection and subsections (e) and (f).

(11) If the employer fails to meet any requirement imposed under this subsection or subsection (e) or (f) or under any obligation undertaken to comply with the requirement of this subsection or subsection (e) or (f), he is liable to the United States for a civil penalty of an amount equal to the amount involved in such failure. The preceding sentence shall not apply if the taxpayer corrects such failure (as determined by the Secretary of the Treasury or his delegate) within 90 days after notice thereof. For purposes of this paragraph, the term "amount involved" means an amount determined by the Secretary or his delegate, but not in excess of 1 percent of the qualified investment of the taxpayer for the taxable year under section 46(a)(2)(B) and not less than the product of one-half of one percent of such amount multiplied by the number of months (or parts thereof) during which such failure continues. The amount of such penalty may be collected by the Secretary of the Treasury in the same manner in which a deficiency in the payment of Federal income tax may be collected.

(12) Notwithstanding any provision of the Internal Revenue Code of 1954 to the contrary, no deduction shall be allowed under section 162, 212, or 404 of such Code for amounts transferred to an employee stock ownership plan and taken into account under this subsection.

(13) (A) As reimbursement for the expense of establishing the plan, the employer may withhold from amounts due the plan for the taxable year for which the plan is established, or the plan may pay, so much of the amounts paid or incurred in connection with the establishment of the plan as does not exceed the sum of 10 percent of the first $100,000 that the employer is required to transfer to the plan for that taxable year under paragraph (6) (including any amounts transferred under subsection (e)(3)) and 5 percent of any amount in excess of the first $100,000 of such amount.

(B) As reimbursement for the expense of administering the plan, the employer may withhold from amounts due the plan, or the plan may pay, so much of the amounts paid or incurred by the employer during the taxable year as expenses of administering the plan as does not exceed the smaller of—

(i) The sum of 10 percent of the first $100,000 and 5 percent of any amount in excess of $100,000 of the income from dividends paid to the plan with respect to stock of the employer during the plan year ending with or within the employer's taxable year, or

(ii) $100,000.

(14) The return of a contribution made by an employer to an employee stock ownership plan designed to satisfy the requirements of this subsection or subsection (e) (or a provision for such a return) does not fail to satisfy the requirements of this subsection, subsection (e), section 401(a) of the Internal Revenue Code of 1954, or section 403(c)(1) of the Employee Retirement Income Security Act of 1974 if—

(A) The contribution is conditioned under the plan upon determination by the Secretary of the Treasury that such plan meets the applicable requirements of this subsection, subsection (e), or section 401(a) of such Code.

(B) The application for such a determination is filed with the Secretary not later than 90 days after the date on which the credit under section 38 is allowed, and

(C) The contribution is returned within one year after the date on which the Secretary issues notice to the employer that such plan does not satisfy the requirements of this subsection, subsection (e), or section 401(a) of such Code.

(e) *Plan requirements for taxpayers electing additional one-half percent credit.*

(1) *General rule.* For purposes of clause (ii) of section 46 (a)(2)(B) of the Internal Revenue Code of 1954, the amount determined under this subsection for a taxable year is an amount equal to the sum of the matching employee contributions for the taxable year which meet the requirements of this subsection.

(2) *Election; basic plan requirements.* No amount shall be determined under this subsection for the taxable year unless the corporation elects to have this subsection apply for that year. A corporation may not elect to have the provisions of this subsection apply for a taxable year unless the corporation meets the requirements of subsection (d) and the requirements of this subsection.

(3) *Employer contribution.* On making a claim for credit, adjustment, or refund under section 38 of the Internal Revenue Code of 1954, the employer shall state in such claim that the employer agrees, as a condition of receiving any such credit, adjustment, or refund attributable to the provisions of section 46 (a)(2)(B)(ii) of such Code, to transfer at the time described in subsection (d)(6)(B) employer securities (as defined in subsection (d)(9)(A)) to the plan having an aggregate value at the time of the transfer of not more than one-half of one percent of the amount of the qualified investment (as determined under subsections (c) and (d) of section 46 of such Code) of the taxpayer for the taxable year. For purposes

of meeting the requirements of this paragraph, a transfer of cash shall be treated as a transfer of employer securities if the cash is, under the plan, used to purchase employer securities.

(4) *Requirements relating to matching employee contributions.*

(A) An amount contributed by an employee under a plan described in subsection (d) for the taxable year may not be treated as a matching employee contribution for that taxable year under this subsection unless—

(i) Each employee who participates in the plan described in subsection (d) is entitled to make such a contribution,

(ii) The contribution is designated by the employee as a contribution intended to be used for matching employer amounts transferred under paragraph (3) to a plan which meets the requirements of this subsection, and

(iii) The contribution is in the form of an amount paid in cash to the employer or plan administrator not later than 24 months after the close of the taxable year in which the portion of the credit allowed by section 38 of such Code (and determined under clause (ii) of section 46 (a)(2)(B) of such Code which the contribution is to match) is allowed, and is invested forthwith in employer securities (as defined in subsection (d)(9)(A)).

(B) The sum of the amounts of matching employee contributions taken into account for purposes of this subsection for any taxable year may not exceed the value (at the time of transfer) of the employer securities transferred to the plan in accordance with the requirements of paragraph (3) for the year for which the employee contributions are designated as matching contributions.

(C) The employer may not make participation in the plan a condition of employment and the plan may not require matching employee contributions as a condition of participation in the plan.

(D) Employee contributions under the plan must meet the requirements of section 401 (a)(4) of such Code (relating to contributions).

(5) A plan must provide for allocation of all employer securities transferred to it or purchased by it under this subsection to the account of each participant (who was a participant at any time during the plan year, whether or not he is a participant at the close of the year) as of the close of the plan year in an amount equal to his matching employee contributions for the year. Matching employee contributions and amounts so allocated shall be deemed to be allocated under subsection (d)(3).

(f) *Recapture.*

(1) *General rule.* Amounts transferred to a plan under subsection (d)(6) or (e)(3) may be withdrawn from the plan by the employer if the plan provides that while subject to recapture—

(A) Amounts so transferred with respect to a taxable year are segregated from other plan assets, and

(B) Separate accounts are maintained for participants on whose behalf amounts so transferred have been allocated for a taxable year.

(2) *Coordination with other law.* Notwithstanding any other law or rule of law, an amount withdrawn by the employer will neither fail to be considered to be nonforfeitable nor fail to be for the exclusive benefit of participants or their beneficiaries merely because of the withdrawal from the plan of—

(A) Amounts described in paragraph (1), or

(B) Employer amounts transferred under subsection (e)(3) to the plan which are not matched by matching employee contributions or which are in excess of the limitation of section 415 of such Code.

nor will the withdrawal of any such amount be considered to violate the provisions of section 403 (c)(1) of the Employee Retirement Income Security Act of 1974.

(Sec. 301 (d) of the Tax Reduction Act of 1975 (89 Stat. 38) as amended by sec. 802 (b)(7) and sec. 803 (c) and (e) of the Tax Reform Act of 1976 (90 Stat. 1520); sec. 301 (e) and (f) of the Tax Reduction Act of 1975 as added by sec. 803 (d) of the Tax Reform Act of 1976)

[T.D. 7590, 44 FR 4133, Jan. 19, 1979]

§ 1.46–8 Requirements for taxpayers electing additional one-percent investment credit (TRASOP's).

(a) *Introduction*—(1) *In general.* A corporation may elect under section 46(a)(2)(B) of the Code to obtain an additional investment credit for property described in section 46(a)(2)(D). This section provides rules for electing to have the provisions of section 46(a)(2)(B) apply and for implementing an employee stock ownership plan under section 301(d) of the Tax Reduction Act of 1975 ("1975 TRA"). The plan must meet the formal requirements of paragraph (d), and the operational requirements of paragraph (e), of this section. An additional credit may be obtained for the periods described in section 46(a)(2)(D). Unless otherwise indicated, statutory references in this section are to the Internal Revenue Code of 1954.

(2) *Reports.* The returns required by section 6058 (a) must be filed on behalf of a plan established under paragraph (c)(7) of this section, whether or not the plan is qualifed under section 401(a).

(3) *Cross-references.* The following table indicates where in this section provisions appear relating to each provision of section 301 (d) and (f) of the 1975 TRA.

Section 301	Section 1.46-8	Subject
(d)(1)	(c)(7)(i)	Establishing a TRASOP, in general
	(c)(8)(i)	Funding a TRASOP, in general
(2)(A)	(c)(7)(ii)	Type of plan
(B)	(d)(3)	Investment design
(C)	(d)(1)	Plan requirements, in general
(3)	(d)(6)	Allocation
	(b)(8)	Compensation, definition
(4)	(d)(7)	Nonforfeitability
	(d)(9)	Distributions
(5)	(d)(8)	Voting rights
(6)	(c)	Procedures for additional credit
(7)(A)	(c)(7)(ii)	Taxability, non-401(a) TRASOP
(B)	(e)(3)	Allocations under 401(a)
(C)	(e)(3)	Section 410 and section 415 requirements
(8)	(e)(9)	Reductions of investment credit
(9)(A)	(b)(4)	Employer securities, definition
	(f)	Employer securities, requirements
(B)	(b)(7)	Value, definition
(10)	(a)(2)	Reporting requirements
(11)	(h)	Failure to comply
(12)	(c)(10)	Deductibility
(13)	(e) (6) and (7)	Reimbursement for expenses
(14)	(c)(8)(v) and (d)(7)(i).	Contingent contributions
(f)	(d)(7), (e)(8)(vii), (f).	Withdrawals of TRASOP securities

(4) *Temporary regulations.* There is need for immediate guidance with respect to certain provisions contained in this section. For this reason, they are not issued with notice and public procedure under subsection 553 of Title 5 of the United States Code. Accordingly, until superseded by final regulations, the following provisions in this section are deemed effective only as temporary regulations under § 9.2, Temporary Income Tax Regulations under the Tax Reduction Act of 1975:

(i) The last sentence of paragraph (b)(4)(i);

(ii) Paragraph (b)(8);

(iii) Paragraph (c) (1), (8), and (9) (iv);

(iv) Paragraph (d)(2);

(v) The last sentences of subparagraphs (5) and (6)(iv) of paragraph (d);

(vi) Paragraph (d)(6) (ix) and (xii);

(vii) The last sentence of paragraph (d)(7);

(viii) Paragraph (e) (6) and (7);

(ix) The last three sentences of paragraph (e)(8)(i);

(x) Paragraph (e)(8)(iii) and (9)(vii),(viii), and (ix);

(xi) Paragraph (f); and

(xii) Paragraph (h) (4).

(b) *Definitions.* When used in this section, the terms listed below have the indicated meanings:

(1) *TRASOP.* A "TRASOP" is an employee stock ownership plan that meets the requirements of section 301 (d) of the 1975 TRA. See § 1.46-7. It is a type of plan described in paragraph (d)(1) of this section and may, but need not, be an ESOP under § 54.4975-11 of this chapter (Pension Excise Tax Regulations).

(2) *Additional credit.* An "additional credit" is the additional one-percent investment credit under section 46(a)(2)(B)(i).

(3) *Employer.* An "employer" is a corporation that establishes a TRASOP.

(4) *Employer securities*—(i) *In general.* "Employer securities" are common stock, and securities convertible into common stock, of the employer or of a corporation that is a member of a controlled group of corporations including the employer. Employer securities must meet the requirements of paragraph (g) of this section. *Membership in a controlled group for purposes of this section is determined under section 414(b) of the Code.*

(ii) *Pre-1977 employer securities.* In addition, employer securities acquired by a TRASOP before January 1, 1977, include common stock, and securities convertible into common stock, of a corporation in control of the employer within the meaning of section 368(c).

(iii) *Caution.* An employer security under this section is not necessarily a qualifying employer security as defined in section 407(d)(5) of the Employee Retirement Income Security Act of 1974 (ERISA) or section 4975

(e)(8). Moreover, sections 406, 407, and 408 of ERISA in certain cases in effect limit the acquisition of qualifying employer securities as defined in section 407 (d)(5) of ERISA.

(5) *TRASOP securities.* "TRASOP securities" are employer securities that—

(i) Are transferred to a TRASOP, or acquired with cash transferred to a TRASOP, to obtain an additional credit, and

(ii) Except as provided under paragraph (g) (4) and (5) of this section or as required by applicable law, are subject to no other put, call, or other option, or buy-sell or similar arrangement while held by the plan.

(6) *Publicly traded.* The term "publicly traded" has the meaning specified in § 54.4975-7(b)(1)(iv) of this chapter.

(7) *Value*—(i) *In general.* With respect to the transfer of TRASOP securities by a corporation to a TRASOP or the acquisition of TRASOP securities with cash transferred by a corporation to a TRASOP, "value" means fair market value determined in good faith and based on all relevant factors as of the date of transfer or acquisition of the TRASOP securities. If the plan acquires TRASOP securities from other than a disqualified person within the meaning of section 4975(e)(2), a good faith determination of value includes a determination of fair market value based on an appraisal independently arrived at by a person who customarily makes such appraisals and who is independent of any person from whom the TRASOP securities are acquired.

(ii) *Twenty-day average rule.* A special 20-day average valuation rule applies to certain publicly traded securities transferred by a corporation to a TRASOP. It does not apply to securities acquired with cash transferred by a corporation to a TRASOP. Under the special rule, the term "value" refers to an average of daily closing prices for a security, as reported on any national securities exchange or as quoted on any system sponsored by a national securities association, over the 20 consecutive trading days immediately preceding the date on which a corporation files a claim for an additional credit. The average is based on the closing prices for each day when the security is in fact traded during the 20-day period. However, the special rule does not apply unless the security is in fact traded for at least 10 of the 20 days.

(iii) *20-day-average transitional exception.* If a TRASOP security is transferred before March 20, 1979, the plan may value the security on the basis of the 20 consecutive trading days preceding the date on which the security is transferred or the date as of which the security is allocated to a participant's account.

(8) *Compensation. "Compensation" means "participant's compensation" under section 415(c)(3).* However, except for purposes of applying section 415, compensation must be determined for a plan year, not a limitation year.

(c) *Procedures for additional credit*—(1) *Applicable year*—(i) *General rule.* With respect to a qualified investment, the "applicable year" of a corporation is the taxable year in which the investment is made.

(ii) *Carryover option.* A corporation may consistently determine the applicable years for all qualified investments made in taxable years beginning after December 31, 1976, under the following option: The first applicable year is the year the qualified investment is made or, if later, the first taxable year for which any additional credit is claimed for that qualified investment. If there is an investment credit carryover from the first applicable year, each taxable year to which any part of the additional credit for that qualified investment is carried over is also an applicable year.

(iii) *Increased credit.* A taxable year in which a corporation's additional credit is increased because of a redetermination is also an applicable year. See paragraph (c)(9)(iii) of this section.

(iv) *Illustration.* To illustrate the application of paragraph (c)(1) (i) and (ii) of this section, assume that a calendar year corporation makes a qualified investment in 1977 and that 1977 is not an unused credit year described in section 46(b)(1). If the general rule is applied, 1977 generally is an applica-

ble year. However, if 1977 is an unused credit year, under section 46 (b)(1), if the corporation carries over its entire investment credit for 1977 to 1978, and if the corporation does not treat 1977 as an applicable year, then 1978 is an applicable year. If part of the investment credit is carried over further to 1979, the year 1979 is also an applicable year.

(2) *Time and manner of electing.* A corporation with a qualified investment must elect to be eligible for an additional credit by attaching a statement of election—

(i) To its income tax return, filed on or before the due date including extensions of time, for its first applicable year with respect to a qualified investment, or

(ii) In the case of a return filed before December 31, 1975, to an amended return filed on or before December 31, 1975.

(3) *Statement of election.* The statement of election must contain the name and taxpayer identification number of the corporation. Also, it must declare in the following words, or in words having substantially the same meaning, that:

(i) The corporation elects to have section 46(a)(2)(B)(i) of the Internal Revenue Code of 1954 apply; and

(ii) The corporation agrees to implement (or continue to implement, as appropriate) a TRASOP and to claim the additional credit as required by § 1.46-8 of the Income Tax Regulations.

(4) *Separate election.* A separate election must be made for each taxable year's qualified investment to obtain an additional credit for that qualified investment. If a corporation does not make a timely election to obtain an additional credit for a taxable year, it may not subsequently make the election on an amended return or otherwise.

(5) *No partial election.* An election to obtain an additional credit applies to a corporation's entire qualified investment for a taxable year. Thus, a corporation may not elect to obtain a partial additional credit for any year's qualified investment. However, the partial disallowance of an additional credit will not result in an election being treated as a partial election. Also an election by a member of a controlled group of corporations that applies only to the electing member's qualified investment is not a partial election.

(6) *No revocation of election.* After the time for electing the additional credit has expired for a taxable year, a corporation may not revoke its election for that year.

(7) *Establishing a TRASOP*—(i) *In general.* A corporation electing to obtain an additional credit must establish a TRASOP with accompanying trust on or before the last day for making the election regardless of when in fact the election is made. A TRASOP is considered to be in existence on a particular date if it meets the requirements of § 1.410(a)-2(c) (1). A new plan need not be established if an existing plan qualifies as a TRASOP, or is amended to meet the requirements of this section, on or before the last day for making the election. The requirements of this section are not satisfied merely by establishing and crediting a separate "TRASOP" account on the corporation's books.

(ii) *Type of plan.* A TRASOP need not meet the requirements of section 401(a). However, it must be a stock bonus plan, a combination stock bonus plan and money purchase pension plan, or a profit-sharing plan under § 1.401.-1(b)(1) of this chapter. See section 301(d)(7)(A) of the 1975 TRA for the tax consequences relating to a TRASOP that does not meet the requirements of section 401(a). See also Title I of ERISA for additional provisions applicable to a TRASOP as an employee pension benefit plan under section 3(2) of ERISA.

(8) *Funding a TRASOP*—(i) *In general.* A corporation electing to obtain an additional credit must fund its TRASOP by transferring TRASOP securities or cash to it no later than 30 days after the applicable last day. That days is the last day for electing the additional credit. However, in the case of an investment credit that was carried over and claimed in a subsequent applicable year by reason of paragraph (c)(1)(ii) of this section, that day is the last day (including extensions) for filing its income tax

return for the subsequent applicable year. TRASOP securities may be transferred to a plan at any time during the applicable year, but not before the first day of an applicable year. If TRASOP securities are transferred to the plan within the permissible time period after the close of the applicable year, they are treated as transferred during that applicable year first until all TRASOP securities required by this paragraph (c) for that applicable year are transferred to, and taken into account under, the TRASOP. Thus, for example, assume that a calendar-year corporation claims an additional credit of $5,000 for 1978, an applicable year under the TRASOP. The corporation also expects to be able to claim an additional credit of $10,000 for 1979. TRASOP securities transferred between January 1, 1979, and October 15, 1979, must be taken into account under the plan for 1978 before they are taken into account for 1979.

(ii) *Cash transfers.* A corporation may transfer cash to the TRASOP instead of TRASOP securities only if the TRASOP uses the cash to acquire TRASOP securities no later than 30 days after the time for funding the TRASOP.

(iii) *Valuation.* The value of the TRASOP securities for an applicable year must equal one percent of the corporation's qualified investment for that year. However, if paragraph (c)(1)(ii) of this section is followed by a corporation, the value of TRASOP securities for an applicable year must equal the amount of additional credit claimed for that year.

(iv) *Cash reserve.* The value of TRASOP securities acquired with cash transferred by a corporation may be reduced by two items. The first item is an amount not more than the value of fractional shares allocable to participants entitled to receive an immediate distribution at the time of the transfer. The second item is start-up expenses and administrative expenses to the extent permitted under section 301(d)(13) of the 1975 TRA and paragraph (e)(6) and (7) of this section.

(v) *Conditional funding.* The funding of a TRASOP may be conditional if the TRASOP satisfies the provisions of section 301(d)(14) of the 1975 TRA. For purposes of section 301(d)(14), an investment credit is considered to be allowed on the date the election for the applicable year is made under paragraph (c)(2) of this section.

(vi) *Certain benefit offset mechanisms.* A TRASOP will be deemed to be underfunded to the extent that TRASOP securities are used to offset benefits under a defined benefit plan.

(9) *Claiming additional credit*—(i) *In general.* Section 46 (a)(3) subjects the amount of investment credit earned with respect to a taxpayer's qualified investment for a taxable year to a limitation based on the corporation's tax liability.

(ii) *Unused credit year.* Section 46 (a) (1) provides a first-in-first-out rule for the investment credit in a taxable year. Section 46(b)(1) provides for the carryback and carryover of unused credits. If less than all of a taxpayer's credit earned for a taxable year is allowed, the 10 percent credit determined under section 46(a)(2)(A) for a particular year is allowed first. Any portion of the additional credit for a taxable year that is not allowed may be carried back or carried over to the extent permitted by section 46(b)(1). However, an additional credit which is allowed for a taxable year is not reduced by a carryback to that year of an unused credit from a succeeding taxable year.

(iii) *Example.* Paragraph (c)(9)(ii) of this section is illustrated by the following example:

Example. A calendar-year corporation begins operation and establishes a TRASOP in 1975. The facts and treatment relating to the corporation's qualified investments and investment tax credits for 1975 and 1976 are as follows:

	1975	1976
Facts:		
1. Qualified investment	$500,000	$500,000
2. Credits earned:		
a. 10% credit	50,000	50,000
b. Additional credit	5,000	5,000
c. Carryover of additional credit from prior year line 5		3,000
3. Sec. 46(a)(3) limitation	52,000	47,000

	1975	1976
Treatment of credits:		
4. Credits allowed:		
a. Carryover of additional credit		3,000
b. Current 10% credit	50,000	44,000
c. Current additional credit	2,000	0
5. Unused credits:		
a. 10% credit	0	6,000
b. Additional credit	3,000	5,000

Thus, in 1975 the section 46(a)(3) limitation ($52,000) is applied first to allow all of the 10 percent investment credit ($50,000). Accordingly only $2,000 of the additional credit earned is allowed in 1975 and $3,000 of the additional credit is carried forward to 1976. In 1976, section 46(a)(1) requires that this $3,000 of additional credit is allowed first, and then only $44,000 of the 10 percent credit earned in 1976 is allowed since the section 46(a)(3) limitation for that year is $47,000. The unused credits from 1976 cannot be carried back since 1975, the only prior year, is an unused credit year.

(iv) *Redeterminations increasing credit.* If a corporation's allowable additional credit is increased because of a redetermination, the increase is treated as if it were an unused credit carryover for purposes of paragraph (c)(1)(ii) and (c)(8)(i) of this section. Thus, for example, assume that a calendar-year corporation claims an additional credit of $100,000 in 1978 because of a qualified investment in that year. In 1980 the additional credit is redetermined to be $110,000. With respect to the 1978 qualified investment, 1980 is also an applicable year to the extent of $10,000. The corporation must fund the TRASOP with this $10,000 under paragraph (c)(8) of this section. For purposes of this subdivision (iv), the date of the increase is determined under paragraph (e)(9)(iii) of this section as if it were the date of a reduction.

(10) *Deductions at expiration of carryover period.* Under paragraph (c)(1)(ii) of this section, a corporation that uses no additional credit in the year of a qualified investment may nonetheless treat the year in which the qualified investment is made as the first applicable year. If the 7-year carryover period under section 46(b)(1)(B) expires before the corporation uses the entire additional credit with respect to the qualified investment, contributions attributable to the unused credit are deductible, subject to the limitations of section 404(a), as if made in the taxable year when the carryover period expires.

(d) *Formal plan requirements*—(1) *In general.* To be a TRASOP, a plan must meet the formal requirements of this paragraph (d).

(2) *Plan year.* To be a TRASOP, a plan must specify a plan year that begins with or within the corporation's taxable year.

(3) *Designed to invest primarily in employer securities.* To be a TRASOP, a plan must state that it is designed to invest primarily in employer securities. A TRASOP intended to qualify as an ESOP under § 54.4975-11 must state that it is designed to invest primarily in employer securities that are qualifying employer securities.

(4) *Separate accounting.* To be a TRASOP, a plan must state that TRASOP securities are to be accounted for separately from other contributions to the plan.

(5) *Debts and expenses of the TRASOP.* To be a TRASOP, a plan must state that TRASOP securities cannot be used to satisfy a loan made to the TRASOP or be used as collateral for a loan made to a TRASOP. *However, if the plan so provides, to the extent permitted under section 301(d)(13) of the 1975 TRA and paragraph (e) (6) and (7) of this section, certain amounts may be used for the TRASOP's start-up expenses and administrative expenses.*

(6) *Allocation of TRASOP securities*—(i) *General rules.* To be a TRASOP, a plan must provide for the allocation of TRASOP securities under section 301(d)(3) of the 1975 TRA and this subparagraph (6).

(ii) *Timing.* TRASOP securities are allocated as of the last day of the plan year beginning with or within the appropriate applicable year.

(iii) *Participants.* Each employee who is a participant at any time during the plan year for which allocation is made must receive an allocation as of the end of that year even though not then employed by the employer.

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However, to receive allocations, employees must satisfy the minimum participation requirements of the plan (for example, 1000 hours of service).

(iv) *Compensation considered.* Compensation in excess of $100,000 must be disregarded in making these allocations. If the plan has a lower stated ceiling on compensation (from $0 to $100,000), compensation in excess of this ceiling must likewise be disregarded. *Also, allocations must be based on a participant's compensation while actually employed, not just while actually participating, in any year.*

(v) *Section 415 priority rule.* If a TRASOP security is not allocated to a participant's account because of section 415 and section 301(d)(3) of the 1975 TRA, no other amount may be allocated for that participant under any defined contribution plan. This subdivision (v) applies to a TRASOP even when, under section 415(f)(1)(B), the TRASOP is treated along with an employer's other defined contribution plans as one plan for purposes of section 415.

(vi) *Unallocated amounts.* Under section 301(d)(3) of the 1975 TRA, TRASOP securities unallocated to participants' accounts because of section 415 must be allocated proportionately to the accounts of other participants until the addition to the account of each participant reaches the limits of section 415.

(vii) *Suspense account.* If, after these allocations, TRASOP securities remain unallocated, they must be held in an unallocated suspense account under the TRASOP. Any income produced by these securities must also be held in the account. A plan with such an account will not fail to qualify under section 401(a) merely because of the account. In each successive year (whether or not an applicable year), the unallocated assets are released from this account for allocation on a first-in-first-out basis. They are then allocated to the participants' accounts proportionately under paragraph (d)(6) (i)-(vi) of this section for each later year until no TRASOP securities remain unallocated. Value for this allocation is determined under paragraph (b)(7) of this section by treating the date as of which allocation occurs as either the date of transfer or, if the special 20-day average rule is otherwise applicable, the date on which the corporation files a claim for an additional credit.

(viii) *Escrow account.* A TRASOP may provide for the establishment of an escrow account instead of a suspense account. The escrow account must satisfy paragraph (d)(6)(vii) of this section. The beneficiary of the escrow account is to be the TRASOP. The corporation may establish the escrow account and contribute stock or cash to it. In such a case, the escrow agent must transfer assets to the plan each year equal to the amount to be allocated proportionately under paragraph (d) (6) (i)-(vi) of this section. Assets held in an escrow account are plan assets.

(ix) *Treatment of certain plan terminations.* To be a TRASOP, a plan must provide that, if a plan terminates because the corporation ceases to exist, unallocated amounts described in paragraph (d)(6)(vi) of this section must be allocated to the extent possible under section 415 for the year of termination. The remaining unallocated amounts must then be withdrawn. These unallocated amounts are treated as recaptured under all the rules of paragraph (e)(9)(vii) of this section except its last sentence. Section 301(f)(2), but not (1), of the 1975 TRA applies to this withdrawal.

(x) *No integration.* Under section 301(d)(3) of the 1975 TRA, no TRASOP may be integrated, directly or indirectly, with contributions or benefits under Title II of the Social Security Act or any other State or Federal law.

(xi) *Fractional securities.* Under section 301(d)(3) of the 1975 TRA, participants' accounts are to be allocated fractional securities or fractional rights to securities.

(xii) *Accounting for amounts withheld by employer or paid by plan as start-up or administrative expenses.* An employer may withhold certain start-up and administrative expenses from TRASOP securities due the plan. Also, a plan may reduce amounts to be allocated to the extent that certain plan assets are used to reimburse the employer, for example for salaries of

employees providing services to the plan, or to pay fees directly to independent contractors for expenses. These expenses do not reduce the amount of additional credit claimed and are not allowable as expenses in computing taxable income. Additional rules concerning these expenses are in paragraph (e) (6) and (7) of this section.

(7) *Nonforfeitability.* To be a TRASOP, a plan must state that each participant has a nonforeitable right to allocated TRASOP securities. For purposes of this section, forfeitures described in section 411(a)(3) are not permitted. However, amounts shall not fail to be considered to be nonforfeitable if the plan provides for their return to the corporation—

(i) In the case of conditional contributions, under section 301 (d) (14) of the 1975 TRA, and

(ii) In the case of investment credit recapture or an event deemed to be a recapture, under section 301 (f) of the 1975 TRA.

(8) *Voting rights*—(i) *Provision for passthrough.* To be a TRASOP, a plan must state that each participant is entitled to direct a designated fiduciary how to exercise any voting rights on TRASOP securities allocated to the account of the participant. The plan need not permit participants to direct the voting of unallocated TRASOP or other securities held by the trust. It may authorize the designated fiduciary to exercise voting rights for unallocated securities.

(ii) *Notification by the employer.* To be a TRASOP, the plan must obligate the corporation to furnish the designated fiduciary and participants with notices and information statements when voting rights are to be exercised. The time and manner for furnishing participants with a notice or information statement must comply with both applicable law and the corporation's charter and by-laws as generally applicable to security holders. In general, the content of the statement must be the same for plan participants as for security holders in general.

(iii) *Fractional securities.* To be a TRASOP, the plan must allow the participants to vote any fractional securities or fractional rights to securities. This requirement is met if the designated fiduciary votes the combined fractional securities or rights to the extent possible to reflect the direction of the participants holding them.

(iv) *Unexercised voting rights.* To be a TRASOP, the plan may not permit the designated fiduciary to exercise voting rights which a participant fails to exercise. However, the plan may permit the solicitation and exercise of participants' voting rights by management and others under a proxy provision applicable to all security holders.

(9) *Distributions*—(i) *In general.* To be a TRASOP, a plan must permit the distribution of allocated TRASOP securities only as provided under section 301(d)(4) of the 1975 TRA. Also, under § 1.401-1(b)(1)(i) of this chapter, to the extent that a TRASOP is a money purchase pension plan, it can only provide for a distribution in the case of separation from service, death, or disability. No TRASOP may provide for the distribution of TRASOP securities upon plan termination within the 84-month holding period. For purposes of section 301(d)(4) of the 1975 TRA, the 84-month holding period begins on the date as of which TRASOP securities are allocated.

(ii) *Certain fractional securities.* A stock bonus TRASOP may distribute cash instead of fractional securities.

(e) *Operational plan requirements*—(1) *General rule.* To be a TRASOP, a plan in operation must meet the requirements of this paragraph (e). However, the provisions under paragraph (e)(8) of this section apply only to TRASOP's qualified under section 401(a).

(2) *Compliance with plan provisions.* To be a TRASOP, a plan must operate in compliance with its provisions.

(3) *Compliance with certain Code provisions.* To be a TRASOP, a plan must meet the requirements of section 301(d)(7) of the 1975 TRA. Thus, whether or not it is qualified under section 401(a), a TRASOP must meet the requirements of section 401(a) with respect to allocations, section 410 with respect to participation, and section 415 with respect to limitations on contributions and benefits. However, these requirements are modified by

paragraph (d)(6) of this section, relating to allocations and section 415.

(4) *Employee contributions.* Under a TRASOP, the receipt of benefits attributable to TRASOP securities must not depend on contributions by participants. If a corporation has a plan in existence which requires employee contributions, a portion of the plan may be a TRASOP if employee contributions are not required with respect to that portion of the plan.

(5) *Controlled group of corporations, etc.* Whether or not a TRASOP is qualified under section 401(a), all employees who by reason of section 414 (b) and (c) are treated as employees of an electing corporation are treated as employed by the corporation in determining whether the plan satisfies the requirements of sections 301(d)(7) (B) and (C) of the 1975 TRA. A member of a controlled group under paragraph (b)(4)(i) of this section with a qualified investment but with no actual employees may obtain an additional credit even though the only participants in the corporation's TRASOP are actually employed by another member of the controlled group.

(6) *Start-up expenses*—(i) *In general.* For purposes of this section, the term "start-up expense" means any ordinary and necessary amount of a nonrecurring nature paid or incurred by the corporation or by the plan in connection with the establishment of a TRASOP under paragraph (c)(7) of this section. Thus, for example, start-up expenses may include expenses relating to: the drafting or amending of plan documents to establish a TRASOP under section 301 (d) or (e) of the 1975 TRA, the seeking of agency approval for these documents and related transactions, the obtaining of shareholder approval for establishing a TRASOP, and the registering of securities for initial funding of a TRASOP.

(ii) *Treatment of start-up expenses.* Start-up expenses may be withheld by the employer, from amounts that would otherwise be due the plan under paragraph (c)(8) of this section, to the extent that these amounts are known by the employer when funding first occurs for an applicable year. To the extent that these amounts are not withheld by the employer, the plan may pay remaining amounts from plan assets within a reasonable time after the amounts are known by the plan.

(iii) *Ceiling on start-up expenses.* Reimbursement for start-up expenses is limited to a ceiling. This ceiling is the sum of 10 percent of the first $100,000 that an employer is first required to transfer under paragraph (c)(8) of this section for an applicable year and 5 percent of that amount in excess of $100,000. If this first year is an unused credit year from which there is a carryover, amounts required to be transferred in subsequent years for claiming carryovers from this first year are considered in determining this ceiling. Thus, for example, assume that a calendar-year corporation first earns an additional credit in 1977 of $9,000 and that $3,000 of this amount is claimed on the income tax return for 1977, for 1978 and for 1979. The corporation's ceiling on start-up expenses is $300 when its 1977 return is filed. The ceiling increases to $600 when its 1978 return is filed and to $900 when its 1979 return is filed, with the claiming of an additional $3,000 credit for each of the three years.

(iv) *Special rule for taxable years ending before January 1, 1977.* Special treatment is available for expenses paid or incurred before January 1, 1977, that were not taken into account in the manner provided by section 301(d)(13) of the 1975 TRA. These expenses may be withdrawn under paragraph (e)(9)(vii) of this section as reductions in the corporation's additional credit caused by a recapture. This withdrawal may only be made during the first taxable year ending after March 20, 1979. It is subject to the ceilings of section 301(d)(13) of the 1975 TRA. Expenses previously deducted by a corporation must be reduced on a timely-filed amended return by the amount of this withdrawal.

(7) *Administrative expenses*—(i) *In general.* For purposes of this section, the term "administrative expense" means any amount, other than a start-up expense, paid or incurred by the corporation or by the plan that is ordinary and necessary in maintaining the

TRASOP. Thus, for example, administrative expenses may include expenses relating to: the compensating of plan fiduciaries and administrators, the leasing of office space and equipment, the reproducing and mailing of information to participants and beneficiaries, and the filing of reports, returns, and amendments relating to a TRASOP. Paragraph (e)(6) (ii) and (iv), relating to treatment of start-up expenses and to a special rule for taxable years ending before January 1, 1977, also applies to administrative expenses.

(ii) *Ceiling on administrative expenses.* Reimbursement for administrative expenses under paragraph (e)(6)(ii) of this section is limited to the smaller of two amounts for each plan year. The first amount is $100,000. The second amount is the sum of 10 percent of the first $100,000 of dividend income paid with respect to TRASOP securities held by the plan during the plan year ending with or within the corporation's taxable year and 5 percent of any such dividend income in excess of $100,000.

(8) *TRASOP qualification under section 401(a)—*(i) *Permanence.* A TRASOP is not required to be a qualified plan under section 401(a). However, to meet the requirements of section 401(a), a TRASOP must be a permanent plan, as described in § 1.401-1(b)(2) of this chapter. Under section 401(a)(21), a plan will not fail to be considered permanent merely because the amount of employer contributions under the plan is determined solely by reference to the amount of additional credit claimed under this section. Thus, for example, it will not fail to be considered permanent merely because employer contributions are not made for a year for which an additional credit is not available by reason of no qualified investment for which an additional credit can be obtained. Section 401(a)(21) applies only to the extent the TRASOP is funded with TRASOP securities and cash in lieu of TRASOP securities.

(ii) *Partial discontinuance of contributions.* A plan that meets the requirements of section 401(a) may receive contributions of TRASOP securities as well as other contributions. If the other contributions continue on a permanent basis, the plan's qualification under section 401(a) will not be adversely affected merely because TRASOP securities cease to be contributed to it.

(iii) *Income distribution.* Income paid with respect to employer securities acquired by a TRASOP may be distributed at any time after receipt by the plan to participants on whose behalf such securities have been allocated without adversely affecting the qualified status of the plan under section 401(a). (See the last sentence of section 803(h), Tax Reform Act of 1976.) However, under a TRASOP that is a stock bonus or profit-sharing plan, income held by the plan for a 2-year period or longer must be distributed under rules generally applicable to stock bonus and profit-sharing plans qualified under section 401(a).

(9) *Reductions in investment credit—*(i) *General rule.* Certain reductions in a corporation's investment credit result from either a recapture under section 47 of the corporation's investment credit or a redetermination of the allowable credit. If these reductions are taken into account under a TRASOP, the plan may only use one or more of the methods described in paragraph (e)(9) (v), (vi), and (vii) of this section for taking into account these reductions. Thus, for example, more than one method is permitted upon a recapture with respect to a qualified investment made in a particular year. However, the method described in paragraph (e)(9)(vii) of this section applies only to a recapture and not to a redetermination.

(ii) *Ratable reduction.* A reduction is allocated ratably between the 10-percent credit and the additional credit. Thus, for example, if a calendar-year corporation claims a $33,000 investment credit for 1976, including a $3,000 additional credit, and $11,000 of the total credit is recaptured in 1978, the $3,000 additional credit is reduced by $1,000. This subdivision (ii) does not apply to a reduction solely of the additional credit as could occur, for example, in the case of a redetermination caused by a mathematical error in computing the additional credit or in the case of a recapture caused by a

bad faith failure to comply under paragraph (h) of this section.

(iii) *Date of reduction.* A reduction in investment credit occurs under this paragraph (e)(9) on the earliest of these dates: (A) The date an income tax return (or an amended return) is filed reflecting the reduction; (B) the date a judicial determination affecting the amount of the reduction becomes final; and (C) the date specified in a closing agreement made under section 7121 is approved by the Commissioner. For purposes of this subdivision (iii), a judicial determination becomes final at the time prescribed in § 1.547-2(b)(1) (ii) or (iii), relating to personal holding company tax.

(iv) *Year for taking reduction into account.* A reduction in investment credit must be taken into account in the earliest year or years possible under the applicable method beginning no later than the year in which the date of the reduction falls.

(v) *Decrease future contributions.* The reduction may be taken into account as a decrease in the value of TRASOP securities to be transferred to the plan.

(vi) *Deduct under section 404.* On the date of the reduction, the reduction may be treated an an amount paid to the TRASOP for purposes of, and as a deduction to the extent allowed under, section 404.

(vii) *Withdraw TRASOP securities.* If an additional credit allowed for a taxable year is recaptured, the corporation may withdraw from the plan TRASOP securities transferred to, or acquired by, the plan for claiming that year's credit. If the plan has converted these securities into other assets, the withdrawal may be of these other assets. In either case, the withdrawal must only be from assets segregated under paragraph (f)(2) of this section and must be first from assets accounted for in an unallocated suspense account for the particular year. The amount of assets actually withdrawn bears the same proportion to the amount of assets subject to withdrawal as the amount of additional credit recaptured bears to the amount of additional credit claimed. Thus, for example, if the assets subject to withdrawal consist of 300 shares of one class of employer stock and one-third of the additional credit is recaptured, 100 shares of the stock are withdrawn. However, if the current value of the assets subject to withdrawal exceeds the dollar amount of the additional credit claimed, assets may be withdrawn only to the extent that their current value does not exceed the dollar amount of the recaptured portion of the additional credit. Thus, for example, if the 300 segregated shares in the prior example have a current value of $9,000 and the dollar value of the additional credit claimed is $4,500, when one-third of the additional credit is recaptured, only 50 shares, not 100 shares, are withdrawn. Current value is determined under paragraph (b)(7) of this section by treating the withdrawal date as either the date of transfer or, if the special 20-day average rule is otherwise applicable, the date on which the corporation files a claim for an additional credit. Withdrawals from an individual's account for the year with respect to which recapture occurs must bear the same ratio to the total amount withdrawn for that year as the individual's TRASOP account balance for that year bears to the total TRASOP account balance for that year. In the case of a TRASOP security acquired after March 20, 1979, the corporation may not withdraw it or assets into which it has been converted unless the plan meets the requirements of paragraph (d)(7)(ii) of this section when the plan acquires the TRASOP security.

(viii) *Prior distribution rule.* If a TRASOP distributes an amount allocated with respect to an investment credit for a taxable year and the credit for that year is later recaptured, withdrawals may not reduce participants' accounts below the level to which they would have been reduced had the prior distribution not occurred. Recaptured amounts above this level may only be deducted under paragraph (e)(9)(vi) of this section. They may not be used to decrease future contributions under paragraph (e)(9)(v).

(ix) *Illustration.* Paragraph (e)(9)(viii) of this section operates as follows:

Example. For 1977, a calendar-year corporation claims an additional credit of $10,000. The corporation's TRASOP meets the requirements of section 301(f) of the 1975 TRA. Each of 10 participants under the plan for that year receives an equal allocation of 10 shares valued at $1,000. In 1978, one participant terminates employment and receives a distribution of 10 shares. In 1979, a recapture reduces the 1977 additional credit by $2,000. If the 10 shares had not been distributed, 20 shares would be available for withdrawal, 2 shares from each participant's account. Since 9 participants remain from 1977, only 18 shares are available for withdrawal (2 shares × 9 remaining participants). If these 18 shares are withdrawn, the corporation may take into account 2 shares by deducting their value under paragraph (e)(9)(vi) of this section.

(f) *Section 301(f) withdrawals*—(1) In general. No assets may be withdrawn by a corporation under section 301(f) of the 1975 TRA unless the assets are either TRASOP securities or plan assets into which TRASOP securities have been converted ("withdrawal assets"). Withdrawal assets must meet the segregated accounting requirements of this paragraph. The physical segregation of assets is not required.

(2) *Segregated accounting.* The segregated accounting requirements are that—

(i) Withdrawal assets must be segregated from other plan assets on a taxable-year-by-taxable-year basis; and

(ii) Separate accounts must be maintained on a taxable-year-by-taxable-year basis for each participant on whose behalf withdrawal assets are allocated.

(3) Aggregate plan year accounting. Withdrawal assets for taxable years beginning before October 4, 1976, also meet the segregated accounting requirements if they are aggregated and accounted for in one separate account apart from withdrawal assets in separate accounts for later taxable years.

(g) *Requirements for employer securities*—(1) *General rules.* The term "employer security" does not include stock rights, warrants and options. An employer security that is not common stock must at all times be immediately convertible into common stock that is an employer security at a conversion price which is no greater than the fair market value of that common stock at the time the plan acquires the security.

(2) *Common stock*—(i) *In general.* To be an employer security, common stock must meet certain voting power and dividend right requirements. For purposes of this paragraph (g), stock held by the TRASOP is not treated as outstanding.

(ii) *Dividend right limitations.* If dividend rights are subject to a limitation, then at least 50 percent of the fair market value of the employer's outstanding common stock at the time the common stock is transferred must be subject to the same limitation. However, common stock that satisfies paragraph (g)(3)(ii) of this section is not subject to this subdivision (ii).

(3) *Voting power and dividend rights.* To be an employer security, common stock must have voting power and dividend rights which, when taken together, are "no less favorable" than the voting power and dividend rights of any other common stock issued by the employer. Common stock which meets one of the following tests is "no less favorable".

(i) *Ten-percent shareholder test.* The stock is part of, or identical to, a class of outstanding stock of which at least 50 percent is not owned by 10-percent shareholders. For this purpose, a 10-percent shareholder is one who owns at least 10 percent of the outstanding shares in a class, including shares constructively owned under section 318.

(ii) *Substantial proportionality test.* More than one class of common stock is outstanding and an identical percentage of shares from each class is transferred to the TRASOP.

(iii) *Voting power test.* The stock is part of, or identical to, the existing class of stock having the greatest number of votes per unit of fair market value. For example, assume there are only two classes of common stock, Class A and Class B. Their fair market values per share are $1 and $.50, respectively, and the owner of each share of each class is entitled to one vote per share. Thus, Class B has

2 votes per $1 and Class A has 1 vote per $1. Accordingly, the Class B stock has the greater number of votes per unit of fair market value.

(4) *Right of first refusal.* TRASOP securities may, but need not, be subject to a right of first refusal. However, whether or not the plan is an ESOP, any such right must meet the requirements of § 54.4975-7(b)(9) of this chapter.

(5) *Put option.* A TRASOP security that is transferred to a TRASOP after September 30, 1976, must be subject to a put option if it is not publicly traded when distributed or if it is subject to a trading limitation when distributed. The provisions of § 54.4975-7(b) (10)-(12) and § 54.4975-11(a)(3) of this chapter apply to such securities, whether or not the plan is ESOP.

(6) *Change of employer security status.* In general, a transaction changing the status of a corporation as an employer, or as a member of a controlled group of corporations including the employer, adversely affects the status as employer securities of common stock and securities held by a plan ("old employer securities"). However, common stock and securities ("new employer securities") substituted for old employer securities are treated as if they were the old employer securities if—

(i) The plan is not terminated;

(ii) The transaction causing the change in status of the old employer securities does not result in a recapture under section 47 of any investment credit underlying the transfer to, or acquisition by, the plan of the old employer securities;

(iii) The old employer securities and the new employer securities are of equal value at the time of the transaction changing the status of the old employer securities; and

(iv) The new employer securities otherwise meet the requirements of this section.

(h) *Failure to comply*—(1) *General rule*—(i) *Effect of failure.* If a corporation elects under paragraph (c) (2)-(5) of this section to obtain an additional credit and fails to comply with respect to that credit at any time, it is liable to the United States for a civil penalty equal to the amount involved in the failure to comply. If the corporation fails to comply with respect to an additional credit during the 84-month period described in section 301(d)(4) of the 1975 TRA, it also is not entitled to any portion of that credit. A separate failure to comply occurs for each taxable year in which a failure continues to exist.

(ii) *Illustration of continuing failure's effect.* Assume that in 1975 an additional credit is allowed and a failure to comply occurs in 1975 with respect to that credit. Assume also that in 1976 the 1975 failure continues uncorrected, another additional credit is allowed, and a failure to comply occurs with respect to the 1976 credit. Under these circumstances, on the last day of 1976 three separate failures to comply exist: (*a*) The 1975 failure with respect to the 1975 credit, (*b*) the 1976 failure with respect to the 1975 credit, and (3) the 1976 failure with respect to the 1976 credit.

(2) *Assessment and collection.* The civil penalty must be assessed and collected in the same manner in which a deficiency in the payment of Federal income tax is assessed and collected.

(3) *Exception.* If a failure to comply is corrected within the correction period described in paragraph (h) (5) of this section—

(i) The corporation is not liable for a civil penalty; and

(ii) If the corporation establishes that at the time of the failure a good faith effort to comply was made, its additional credit is not disallowed.

(4) *Failure to comply (penalty classifications)*—(i) *In general.* An electing corporation fails to comply if a defect described in paragraph (h)(4) (ii)-(iv) of this section occurs with respect to an additional credit allowed for a particular taxable year. The characterization of the defect in this subparagraph (4) determines the amount involved under paragraph (h) (8) of this section for the purpose of assessing the civil penalty.

(ii) *Funding defect.* A funding defect occurs if a corporation or its TRASOP fails to satisfy the requirements of paragraph (c) (8) or (9) of this section, relating to funding a TRASOP and claiming an additional credit.

(iii) *Special operational defect.* A special operational defect occurs if a TRASOP fails in operation to satisfy the requirements described in paragraph (d) (5)-(9) of this section, relating to debts and expenses of a TRASOP, allocation of TRASOP securities, nonforfeitability, voting rights, and distributions or paragraph (e) (3) of this section, relating to compliance with certain Code provisions.

(iv) *De minimis defect.* A de minimis defect occurs if a corporation or its TRASOP fails to satisfy any requirement of this section other than those enumerated either in paragraph (h) (4) (ii) and (iii) of this section or in paragraphs (a)(2) and (c) (2)-(5) of this section. A failure to comply under this subdivision (iv) may be formal or operational in nature.

(5) *Failure to comply (correction rules classifications)*—(i) *In general.* If for an electing corporation a defect described in paragraph (h)(4) of this section occurs, the procedure for correcting the failure to comply depends upon whether the failure is classified as a "formal" failure or an "operational" failure under this subparagraph (5).

(ii) *Formal failure to comply.* Formal failures are corrected by retroactive amendment. If a formal plan requirement is not met, the plan must be retroactively amended by no later than the expiration of the correction period under paragraph (h)(6) of this section. A plan fails to meet a formal plan requirement of paragraph (d) of this section if, for example, it does not state, as required by paragraph (d)(3) of this section, that it is designed to invest primarily in employer securities.

(iii) *Operational failure to comply.* Operational failures are corrected by undoing the defective transaction and by making the plan and the participants whole. If the value of TRASOP securities transferred to the TRASOP is less than the amount of the additional credit, the corporation must make up any resulting funding deficiency within the correction period. This is done, for example, by contributing additional TRASOP securities plus an amount equal to the dividends or interest that would have been paid between the time that the TRASOP securities should have been transferred and the actual time of the transfer. The contribution of additional TRASOP securities is based on their value under paragraph (b) (7) of this section as of the date by which they were required to be transferred to the plan. These further contributions are subject to the deduction limits of section 404. An electing corporation fails to meet an obligation undertaken under this section if, for example, it fails to comply with paragraph (c)(8) of this section.

(6) *Correction period*—(i) *In general.* For purposes of this paragraph (h), the "correction period" begins when the failure to comply occurs and ends 90 days after receipt by the corporation of a notice of deficiency under section 6212 with respect to the civil penalty and the investment credit.

(ii) *Extensions of correction period.* Extensions of the correction period are determined under § 53.4941 (e)-1 (d)(2) (i), (ii), and (iv) of this chapter (Foundation Excise Tax Regulations). For this purpose, a failure to comply is treated as an act of self-dealing, the corporation is treated as a foundation, and a civil penalty is treated as a tax under section 4941 (a) (1).

(7) *Good faith.* The corporation has the burden of establishing under paragraph (h)(3)(ii) of this section that it made a good faith effort to comply. For example, if a corporation shows that it has made a good faith effort to establish the fair market value of the employer securities transferred to the TRASOP, it may be entitled to the additional credit even if, on later examination of the return, it is determined that more securities should have been transferred. For purposes of this paragraph (h)(7), reasonable reliance on Technical Information Release 1413 (1975-50 I.R.B. 16), questions and answers relating to ESOP's, is a good faith effort to comply.

(8) *Amount involved*—(i) *In general.* The amount involved in a failure to comply is an amount described in this subparagraph (8). A maximum amount and a minimum amount are determined with respect to an additional credit allowed for a particular taxable year.

(ii) *Maximum amount involved.* Notwithstanding any other rule in this paragraph (h), all amounts involved with respect to an additional credit allowed for a particular taxable year may not exceed the amount of that credit.

(iii) *Minimum amount involved.* The minimum amount is ½ of one percent of the additional credit times the number of full months, or parts of full months, during which the failure to comply exists. "Full month" has the meaning assigned in § 1.1250-1 (d) (4) (Realty depreciation recapture).

(iv) *Funding amount involved.* The amount involved for a funding defect is the greater of the minimum amount involved or the amount required to place the plan in the position it would have been in if no funding defect had occurred.

(v) *Special operational amount involved.* The amount involved for a special operational defect is the maximum amount involved.

(vi) *De minimis amount involved.* The amount involved for a *de minimis* defect is the minimum amount involved.

(Sec. 301 (d) (2) (C) of the Tax Reduction Act of 1975 and sec. 7805 of the Internal Revenue Code of 1954 (89 Stat. 38, 68A Stat. 917 (26 U.S.C. 7805))

[T.D. 7590, 44 FR 4135, Jan. 19, 1979]

§ 1.47-1 Recomputation of credit allowed by section 38.

(a) *General rule*—(1) *In general.* (i) If during the taxable year any section 38 property the basis (or cost) of which was taken into account, under paragraph (a) of § 1.46-3, in computing the taxpayer's qualified investment is disposed of, or otherwise ceases to be section 38 property or becomes public utility property (as defined in paragraph (g) of § 1.46-3) with respect to the taxpayer, before the close of the estimated useful life (as determined under subparagraph (2)(i) of this paragraph) which was taken into account in computing such qualified investment, then the credit earned for the credit year (as defined in subdivision (ii) (*a*) of this subparagraph) shall be recomputed under the principles of paragraph (a) of § 1.46-1 and paragraph (a) of § 1.46-3 substituting, in lieu of the estimated useful life of the property that was taken into account originally in computing qualified investment, the actual useful life of the property as determined under subparagraph (2)(ii) of this paragraph. There shall also be recomputed under the principles of §§ 1.46-1 and 1.46-2 the credit allowed for the credit year and for any other taxable year affected by reason of the reduction in credit earned for the credit year, giving effect to such reduction in the computation of carryovers or carrybacks of unused credit. If the recomputation described in the preceding sentence results in the aggregate in a decrease (taking into account any recomputations under this paragraph in respect of prior recapture years, as defined in subdivision (ii)(*b*) of this subparagraph) in the credits allowed for the credit year and for any other taxable year affected by the reduction in credit earned for the credit year, then the income tax for the recapture year shall be increased by the amount of such decrease in credits allowed. For treatment of such increase in tax, see paragraph (b) of this section. For rules relating to "disposition" and "cessation", see § 1.47-2. For rules relating to certain exceptions to the application of this section, see § 1.47-3. For special rules in the case of an electing small business corporation (as defined in section 1371(b)), an estate or trust, or a partnership, see respectively, §§ 1.47-4, 1.47-5, or 1.47-6. For rules applicable to energy property, see paragraph (h) of this section.

(ii) For purposes of this section and §§ 1.47-2 through 1.47-6—

(*a*) The term "credit year" means the taxable year in which section 38 property was taken into account in computing a taxpayer's qualified investment.

(*b*) The term "recapture year" means the taxable year in which section 38 property the basis (or cost) of which was taken into account in computing a taxpayer's qualified investment is disposed of, or otherwise ceases to be section 38 property or becomes public utility property with respect to the taxpayer, before the close of the estimated useful life which was

taken into account in computing such qualified investment.

(c) The term "recapture determination" means a recomputation made under this paragraph.

(2) *Rules for applying subparagraph (1).* For purposes of subparagraph (1) of this paragraph—

(i) In determining whether section 38 property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing the taxpayer's qualified investment, the term "estimated useful life" means the shortest life of the useful life category within which falls the estimated useful life which was assigned to such property under paragraph (e) of § 1.46-3. Thus, section 38 property which is assigned, under paragraph (e) of § 1.46-3, an estimated useful life of 6 years shall not be treated, for purposes of subparagraph (1) of this paragraph, as having been disposed of before the close of its estimated useful life if such property is sold 5 years (that is, the shortest life of the 5 years or more but less than 7 years useful life category) after the date on which it was placed in service. Likewise, section 38 property with an estimated useful life of 15 years which is placed in service on January 1, 1972, shall not be treated as having been disposed of before the close of its estimated useful life if such property is sold at any time after January 1, 1979 (that is, 7 years or more after the date on which it was placed in service).

(ii) In determining the recomputed qualified investment with respect to property which is disposed of or otherwise ceases to be section 38 property the term "actual useful life" means, except as otherwise provided in this section and §§ 1.47-2 through 1.47-6, the period beginning with the date on which the property was placed in service by the taxpayer and ending with the date of such disposition or cessation. See paragraph (c) of this section.

(iii) In determining the recomputed qualified investment with respect to property which ceases to be section 38 property with respect to the taxpayer after August 15, 1971, or which becomes public utility property after such date, such property shall be treated as if it were property described in section 50 at the time it was placed in service (whether or not it was property described in section 50 at such time). Thus, if property was placed in service on October 15, 1968, and was assigned an estimated useful life of 4 years, there would be no increase in tax under section 47 if the property were disposed of at any time after October 14, 1971, that is, 3 years or more after the property was placed in service.

(b) *Increase in income tax and reduction of investment credit carryover*—(1) *Increase in tax.* Except as provided in subparagraph (2) of this paragraph, any increase in income tax under this section shall be treated as income tax imposed on the taxpayer by chapter 1 of the Code for the recapture year notwithstanding that without regard to such increase the taxpayer has no income tax liability, has a net operating loss for such taxable year, or no income tax return was otherwise required for such taxable year.

(2) *Special rule.* Any increase in income tax under this section shall not be treated as income tax imposed on the taxpayer by chapter 1 of the Code for purposes of determining the amount of the credits allowable to such taxpayer under—

(i) Section 33 (relating to taxes of foreign countries and possessions of United States),

(ii) Section 34 (relating to dividends received by individuals before January 1, 1965),

(iii) Section 35 (relating to partially tax-exempt interest received by individuals),

(iv) Section 37 (relating to retirement income), and

(v) Section 38 (relating to investment in certain depreciable property).

(3) *Reduction in credit allowed as a result of a net operating loss carryback.* (i) If a net operating loss carryback from the recapture year or from any taxable year subsequent to the recapture year reduces the amount allowed as a credit under section 38 for any taxable year up to and including the recapture year, then there shall be a new recapture determination under

paragraph (a) of this section for each recapture year affected, taking into account the reduced amount of credit allowed after application of the net operating loss carryback.

(ii) Subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). (*a*) X Corporation, which makes its return on the basis of a calendar year, acquired and placed in service on January 1, 1962, an item of section 38 property with a basis of $10,000 and an estimated useful life of 8 years. The amount of qualified investment with respect to such asset was $10,000. For the taxable year 1962, X Corporation's credit earned of $700 (7 percent of $10,000) was allowed under section 38 as a credit against its liability for tax of $700. In 1963 and 1964 X Corporation had no liability for tax and placed in service no section 38 property. On January 3, 1963, such item of section 38 property was sold to Y Corporation. Since the actual useful life of such item was only 1 year, there was a recapture determination under paragraph (a) of this section. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1963 was increased by the $700 decrease in its credit earned for the taxable year 1962 (that is, the $700 original credit earned minus zero recomputed credit earned).

(*b*) For the taxable year 1965, X Corporation has a net operating loss which is carried back to the taxable year 1962 and reduces its liability for tax, as defined in paragraph (c) of § 1.46-1, for such taxable year to $200. As a result of such net operating loss carryback, X Corporation's credit allowed under section 38 for the taxable year 1962 is limited to $200 and the excess of $500 ($700 credit earned minus $200 limitation based on amount of tax) is an investment credit carryover to the taxable year 1963.

(*c*) For 1965, there is a recapture determination under subdivision (i) of this subparagraph for the 1963 recapture year. The $700 increase in the income tax imposed on X Corporation for the taxable year 1963 is redetermined to be $200 (that is, the $200 credit allowed after taking into account the 1965 net operating loss minus zero credit which would have been allowed taking into account the 1963 recapture determination). In addition, X Corporation's $500 investment credit carryover to the taxable year 1963 is reduced by $500 ($700 minus $200) to zero and X Corporation is entitled to a $500 refund of the tax paid as a result of the 1963 determination.

Example (2). (*a*) X Corporation, which makes its returns on the basis of a calendar year, acquired and placed in service on January 1, 1962, an item of section 38 property with a basis of $10,000 and an estimated useful life of 8 years. The amount of qualified investment with respect to such asset was $10,000. For the taxable year 1962, X Corporation's credit earned of $700 (7 percent of $10,000) was allowed under section 38 as a credit against its liability for tax of $700. In 1963 and in 1964 X Corporation had no liability for tax and placed in service no section 38 property. On January 3, 1965, such item of section 38 property is sold to Y Corporation. For the taxable year 1965, X Corporation has a net operating loss which is carried back to the taxable year 1962 and reduces its liability for tax, as defined in paragraph (c) of § 1.46-1, for such taxable year to $100.

(*b*) As a result of such net operating loss carryback, X Corporation's credit allowed under section 38 for the taxable year 1962 is limited to $100 and the excess of $600 ($700 credit earned minus $100 limitation based on amount of tax) is an investment credit carryover to the taxable year 1963.

(*c*) Since the actual useful life of the item of section 38 property sold to Y Corporation was only 3 years, there is a recapture determination under paragraph (a) of this section. X Corporation's $600 investment credit carryover to 1963 is reduced by $600 to zero. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1965 is increased by the $100 reduction in credit allowed by section 38 for 1962.

(4) *Statement of recomputation.* The taxpayer shall attach to his income tax return for the recapture year a separate statement showing in detail the computation of the increase in income tax imposed on such taxpayer by chapter 1 of the Code and the reduction in any investment credit carryovers.

(c) *Date placed in service and date of disposition or cessation*—(1) *General rule.* For purposes of this section and §§ 1.47-2 through 1.47-6, in determining the actual useful life of section 38 property—

(i) Such property shall be treated as placed in service on the first day of the month in which such property is placed in service. The month in which property is placed in service shall be determined under the principles of paragraph (d) of § 1.46-3.

(ii) If during the taxable year such property ceases to be section 38 property with respect to the taxpayer—

(*a*) As a result of the occurrence of an event on a specific date (for exam-

ple, a sale, transfer, retirement or other disposition), such cessation shall be treated as having occurred on the actual date of such event.

(*b*) For any reason other than the occurrence of an event on a specific date (for example, because such property is used predominantly in connection with the furnishing of lodging during such taxable year), such cessation shall be treated as having occurred on the first day of such taxable year.

(2) *Special rule.* Notwithstanding subparagraph (1) of this paragraph, if a taxpayer uses an averaging convention (see § 1.167(a)10) in computing depreciation with respect to section 38 property, then, for purposes of this section and §§ 1.47-2 through 1.47-6, he may use the assumed dates of additions and retirements in determining the actual useful life of such property provided such assumed dates are used consistently for purposes of subpart B of part IV of subchapter A of chapter 1 of the Code with respect to all section 38 property for which such convention is used for purposes of depreciation. This subparagraph shall not apply in any case where from all the facts and circumstances it appears that the use of such assumed dates results in a substantial distortion of the investment credit allowed by section 38. Thus, for example, if the taxpayer computes depreciation under a convention under which the average of the beginning and ending balances of the asset account for the taxable year are taken into account, he may use July 1 as the assumed date of all additions and retirements to such account. Similarly, if the taxpayer computes depreciation under a convention under which the average of the beginning and ending balances of the asset account for each month is taken into account, he may use the date determined by reference to the weighted average of the monthly averages as the assumed date of all additions and retirements to such account.

(3) *Example.* This paragraph may be illustrated by the following example:

Example. Assume that section 38 property is placed in service (within the meaning of paragraph (d) of § 1.46-3) on December 1, 1965 (thus, the credit is treated as being earned in 1965) but under the taxpayer's depreciation practice the period for depreciation with respect to such property begins on January 1, 1966, and that the property is actually retired on December 2, 1970. Under the general rule of subparagraph (1) of this paragraph, the property is treated as placed in service on December 1, 1965, and as ceasing to be section 38 property with respect to the taxpayer on December 2, 1970, even though under the taxpayer's depreciation practice the period for depreciation with respect to such property begins on January 1, 1966, and terminates on January 1, 1971. However, under the special rule of subparagraph (2) of this paragraph the taxpayer may determine the actual useful life of the property by reference to the assumed dates of January 1, 1966, and January 1, 1971.

(d) *Examples.* Paragraphs (a) through (c) of this section may be illustrated by the following examples:

Example (1). (i) X Corporation, which makes its returns on the basis of the calendar year, acquired and placed in service on January 1, 1962, three items of section 38 property each with a basis of $12,000 and an estimated useful life of 15 years. The amount of qualified investment with respect to each such asset was $12,000. For the taxable year 1962, X Corporation's credit earned of $2,520 was allowed under section 38 as a credit against its liability for tax of $4,000. On December 2, 1965, one of the items of section 38 property is sold to Y Corporation.

(ii) The actual useful life of the item of property which is sold on December 2, 1965, is three years and eleven months. The recomputed qualified investment with respect to such item of property is zero ($12,000 basis multiplied by zero applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is $1,680 (7 percent of $24,000). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1965 is increased by the $840 decrease in its credit earned for the taxable year 1962 (that is, $2,520 original credit earned minus $1,680 recomputed credit earned).

Example (2). (i) The facts are the same as in example (1) and in addition on December 2, 1966, a second item of section 38 property placed in service in the taxable year 1962 is sold to Y Corporation.

(ii) The actual useful life of the item of property which is sold on December 2, 1966, is four years and eleven months. The recomputed qualified investment with respect to such item of property is $4,000 ($12,000 basis multiplied by 33⅓ percent applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is

$1,120 (7 percent of $16,000). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1966 is increased by $560 (that is, $1,400 ($2,520 original credit earned minus $1,120 recomputed credit earned) reduced by the $840 increase in tax for 1965).

Example (3). (i) The facts are the same as in example (1) except that for the taxable year 1962 X Corporation's liability for tax under section 46(a)(3) is only $1,520. Therefore, for such taxable year X Corporation's credit allowed under section 38 is limited to $1,520 and the excess of $1,000 ($2,520 credit earned minus $1,520 limitation based on amount of tax) is an unused credit. Of such $1,000 unused credit, $100 is allowed as a credit under section 38 for the taxable year 1963, $100 is allowed for 1964, and $800 is carried to the taxable year 1965.

(ii) The actual useful life of the item of property which is sold on December 2, 1965, is three years and eleven months. The recomputed qualified investment with respect to such item of property is zero ($12,000 basis multiplied by zero applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is $1,680 (7 percent of $24,000). If such $1,680 recomputed credit earned had been taken into account in place of the $2,520 original credit earned, X's credit allowed for 1962 would have been $1,520, and of the $160 unused credit from 1962 $100 would have been allowed as a credit under section 38 for 1963, and $60 would have been allowed for 1964. X Corporation's $800 investment credit carryover to the taxable year 1965 is reduced by $800 to zero. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1965 is increased by $40 (that is, the aggregate reduction in the credits allowed by section 38 for 1962, 1963, and 1964).

Example (4). (i) X Corporation, which makes its returns on the basis of the calendar year, acquired and placed in service on November 1, 1962, an item of section 38 property with a basis of $12,000 and an estimated useful life of 10 years. The amount of qualified investment with respect to such property was $12,000. For the taxable year 1962, X Corporation's credit earned of $840 was allowed under section 38 as a credit against its liability for tax of $840. For each of the taxable years 1963 and 1964 X Corporation's liability for tax was zero and its credit earned was $400; therefore, for each of such years its unused credit was $400. For the taxable year 1965 its liability for tax was $200 and its credit earned was zero; therefore, $200 of the $400 unused credit from 1963 was allowed as credit for 1965 and $600 ($200 from 1963 and $400 from 1964) is an investment credit carryover to 1966. On February 2, 1966, such item of section 38 property is sold to Y Corporation.

(ii) The actual useful life of such item of property is three years and three months. The recomputed qualified investment with respect to such property is zero ($12,000 basis multipled by zero) and X Corporation's recomputed credit earned for the taxable year 1962 is zero. If such zero recomputed credit earned had been taken into account in place of the $840 original credit earned, the entire $400 unused credit from 1963 (including the $200 portion which was originally allowed as a credit for 1965) and the $400 unused credit from 1964 would have been allowed as investment credit carrybacks against X Corporation's liability for tax of $840 for 1962. (See § 1.46-2 for rules relating to the carryback of unused credits.)

(iii) Therefore, the $600 carryover from 1963 and 1964 to 1966 is eliminated and the income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1966 is increased by the $240 aggregate reduction in the credits allowed by section 38 for the taxable years 1962 and 1965 (that is, $1,040 credit allowed minus $800 which would have been allowed).

Example (5). (i) X Corporation, which makes its returns on the basis of the calendar year, acquired and placed in service on November 1, 1962, an item of section 38 property with a basis of $10,000 and an estimated useful life of 8 years. The amount of qualified investment with respect to such asset was $10,000. For the taxable year 1962, X Corporation's credit earned of $700 was allowed as a credit against its liability for tax. For each of the taxable years 1963, 1964, and 1965 X had no taxable income. On July 3, 1966, the item of section 38 property is sold to Y Corporation. For the taxable year 1966 X Corporation has a net operating loss of $3,000.

(ii) The actual useful life of the item of property is three years and eight months. The recomputed qualified investment with respect to such item of property is zero and X Corporation's recomputed credit earned for the taxable year 1962 is zero. Notwithstanding the $3,000 net operating loss for the taxable year 1966, the income tax imposed by chapter 1 of the Code on X Corporation for such year is $700 (that is, the decrease in its credit earned for the taxable year 1962).

(e) *Identification of property*—(1) *General rule*—(i) *Record requirements.* In general, the taxpayer must maintain records from which he can establish, with respect to each item of section 38 property, the following facts:

(*a*) The date the property is disposed of or otherwise ceases to be section 38 property,

(*b*) The estimated useful life which was assigned to the property under paragraph (e) of § 1.46-3,

(*c*) The month and the taxable year in which the property was placed in service, and

(*d*) The basis (or cost), actually or reasonably determined, of the property.

(ii) *Recapture determination.* For purposes of determining whether section 38 property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of its estimated useful life, and for purposes of determining recomputed qualified investment, the taxpayer must establish from his records the facts required by subdivision (i) of this subparagraph.

(iii) *Examples.* If the taxpayer fails to maintain records from which he can establish the facts required by subdivision (i) of this subparagraph, then this section shall be applied to the taxpayer in the manner indicated in the following examples:

Example (1). Corporation X, organized on January 1, 1964, files its income tax return on the basis of a calendar year. During the years 1964 and 1965, X places in service several items of machinery to which it assigns estimated useful lives of 8 years. X places the items of machinery in a composite account for purposes of computing depreciation. When X's 1966 return is being audited, X is unable to establish whether the items placed in service in 1964 and 1965 were still on hand at the end of 1966. Therefore, for purposes of paragraph (a) of this section, X is treated as having disposed of, in 1966, all of the items of machinery placed in service in 1964 and 1965.

Example (2). Corporation Y, organized on January 1, 1960, files its income tax return on the basis of a calendar year. During each of the years 1960 through 1965, Y places in service four items of machinery to each of which it assigns an estimated useful life of 8 years for depreciation purposes (and for purposes of computing qualified investment for relevant years). Y places the items of machinery in a composite account for purposes of computing depreciation (and for purposes of computing qualified investment for relevant years). When Y's 1965 return is being audited, Y can establish that it retired during 1965 only six items of this machinery. However, Y cannot establish the date on which these six items were placed in service, nor can Y establish that the items placed in service in 1963 or 1964 are still on hand as of the end of 1965. No previous recapture has taken place with respect to any of the items placed in service in 1963 or 1964. Assuming that paragraph (e) (2) and (3) of this section is not applicable, Y is treated, for purposes of paragraph (a) of this section, as having disposed of, in 1965, the four items placed in service in 1964, the most recent year before 1965 in which such property was placed in service, and two items from 1963, the next most recent year.

Example (3). The facts are the same as in example (2) except that when Y's 1966 return is being audited, Y can establish from its records that all four items placed in service in 1965 are still on hand and that only three items were retired in 1966. For purposes of paragraph (a) of this section, Y is treated as having disposed of, in 1966, the two remaining items of machinery placed in service in 1963, and one of the items placed in service in 1962.

(2) *Treatment of "mass assets".* (i) If, in the case of mass assets (as defined in subparagraph (4) of this paragraph), it is impracticable for the taxpayer to maintain records from which he can establish with respect to each item of section 38 property the facts required by subparagraph (1) of this paragraph, and if he adopts other reasonable recordkeeping practices, consonant with good accounting and engineering practices, and consistent with his prior recordkeeping practices, then he may substitute data from an appropriate mortality dispersion table. An appropriate mortality dispersion table must be based on an acceptable sampling of the taxpayer's actual experience or other acceptable statistical or engineering techniques. In lieu of such mortality dispersion table, the taxpayer may use a standard mortality dispersion table prescribed by the Commissioner. If the taxpayer uses such standard mortality dispersion table for any taxable year, it must be used for all subsequent taxable years unless the taxpayer obtains the consent of the Commissioner to change. If mass assets are placed in a multiple asset account and if the depreciation rate for such account is based on the maximum expected life of the longest lived asset in such account, in applying a mortality dispersion table (including a standard mortality dispersion table) the average expected useful life of the mass assets in such account must be used.

(ii) Subdivision (i) of this subparagraph shall not apply with respect to assets placed in service in a taxable year ending on or after June 30, 1967, and beginning before January 1, 1971, or with respect to assets placed in service for a taxable year beginning after December 31, 1970, for which the taxpayer has not made the election provided by section 167(m), unless the estimated useful lives which were assigned to such assets for purposes of determining qualified investment—

(*a*) Were separate lives based on the estimated range of years taken into account in establishing the average useful life of assets similar in kind under paragraph (e)(3)(ii)(*b*) of § 1.46-3, and

(*b*) Were determined by use of a mortality dispersion table (including a standard mortality dispersion table).

(iii) Any standard mortality dispersion table prescribed by the Commissioner shall be based on average useful life categories and with respect to each category shall contain five columns, the first four of which shall state the percentage of property assumed to have a useful life of—

Column (1): Less than 4 years,
Column (2): 4 years or more but less than 6 years,
Column (3): 6 years or more but less than 8 years, and
Column (4): 8 years or more.

The fifth column shall show the total qualified investment as a percentage and shall be used in connection with the determination to be made under § 1.46-3(e)(3)(iii). In the case of a table which is to apply to property which is described in section 50 or to property which is treated as property described in section 50 under paragraph (a)(2)(iii) of this section, this subdivision shall be applied by substituting "3 years" for "4 years", "5 years" for "6 years", and "7 years" for "8 years".

(iv) Whenever the standard mortality dispersion table is used for a taxable year under subdivision (i) of this subparagraph (whether or not such table was used in determining qualified investment), the percentage of property shown in column (1) of the table shall (for purposes of section 47, this section, and §§ 1.47-2 through 1.47-6) be deemed to have been disposed of on the day before the expiration of the 4-year period beginning on the date on which it was considered as placed in service under § 1.47-1(c); the percentage of property shown in column (2) of the table shall be deemed to have been disposed of on the day before the expiration of the 6-year period beginning on the date on which it was so considered as placed in service; and the percentage of property shown in column (3) shall be deemed to have been disposed of on the day before the expiration of the 8-year period beginning on the date on which it was so considered as placed in service. In applying this subdivision for purposes of recomputing qualified investment, the proper average useful life category shall be used whether or not such category was used in determining qualified investment. In the case of property which is described in section 50 or property which is treated as property described in section 50 under paragraph (a)(2)(iii) of this section (other than property the qualified investment with respect to which was determined by use of the standard or an appropriate mortality dispersion table), this subdivision shall be applied by substituting "3-year period" for "4-year period", "5-year period" for "6-year period", and "7-year period" for "8-year period".

(v) In lieu of using subdivision (iv) of this subparagraph for purposes of recomputing qualified investment, a taxpayer may, for the first recapture year (as defined in paragraph (a)(1)(ii)(*b*) of this section) to which such subdivision (iv) would otherwise apply with respect to any mass asset account, recompute qualified investment on the basis of the difference between (*a*) the proper total qualified investment based on the percentage shown in column (5) of the table, and (*b*) the total qualified investment actually claimed by the taxpayer for the year in which the property was placed in service.

Example. Assume that the taxpayer places in service during 1963 mass assets costing him $100,000, that he places these assets in a multiple asset account for which he properly claims a useful life of 6 years and a qualified investment of $66,667 (⅔ × $100,000), and that he is allowed an invest-

ment credit of $4,667.67. When the taxpayer's 1967 return is being audited he is unable to establish that any of the mass assets placed in service in 1963 were still on hand at the end of 1967.

The taxpayer elects to use the standard mortality dispersion table prescribed by the Commissioner to determine the amount of recapture with respect to these mass assets. Assume that the table prescribed by the Commissioner shows with respect to mass assets with an average useful life of 6 years the following:

Percent of property assumed to have a useful life of—				Total qualified investment (percent)
Less than 4 years	4 years or more, but less than 6 years	6 years or more, but less than 8 years	8 years or more	
(1)	(2)	(3)	(4)	(5)
15.87	34.13	34.13	15.87	50.00

(*a*) Under these circumstances 15.87 percent of the mass assets placed in service in 1963 are deemed to have been disposed of during 1967. With respect to these assets, the amount of qualified investment for 1963 was $10,580 ($15,870 × ⅔) and the amount of credit earned was $740.60 (7 percent of $10,580), whereas the recomputed qualified investment is zero and the recomputed credit earned is zero. Thus, the tax imposed by chapter 1 of the Code for 1967 is increased by $740.60.

(*b*) No recapture determination is required for 1968 since no assets are deemed to have been disposed of in that year. During 1969, 34.13 percent of the mass assets placed in service in 1963 are deemed to have been disposed of. With respect to these assets, the amount of qualified investment for 1963 was $22,753.34 ($34,130 × ⅔) and the amount of credit earned was $1,592.73 (7 percent of $22,753.34), whereas the recomputed qualified investment is $11,376.67 ($34,130 × ⅓) and the recomputed credit earned is $796.37 (7 percent of $11,376.67). Thus, the tax imposed by chapter 1 of the Code for 1969 is increased by $796.36 ($1,592.73 minus $796.37).

(*c*) If the taxpayer chooses to recompute qualified investment by using the method provided in subdivision (v) of this subparagraph, the increase in tax for 1967 (the first recapture year) would be $1,167.67, i.e., the original credit earned, $4,667.67, minus the recomputed credit earned, $3,500 (50 percent, the percentage shown in column (5), of $100,000 multiplied by 7 percent). As long as the same average useful life category reflects the taxpayer's experience for subsequent years, no recapture determination will be required for any future year, except as provided by subparagraph (3)(iv) of this paragraph.

(vi) Subdivision (i) of this subparagraph shall not apply with respect to section 38 property to which an election under section 167(m) applies unless the taxpayer assigns actual retirements of such section 38 property for all taxable years to the same vintage account for purposes of section 47 and for purposes of computing the allowance for depreciation under section 167. The assignment of actual retirements of section 38 property for a taxable year to particular vintage accounts may be made on the basis of an appropriate mortality dispersion table (based on an acceptable sampling of the taxpayer's actual experience or other statistical or engineering techniques) or on the basis of a standard mortality dispersion table prescribed by the Commissioner. If the taxpayer assigns actual retirements for any taxable year to particular vintage accounts on the basis of such standard mortality dispersion table, actual retirements for all subsequent taxable years must be assigned to particular vintage accounts on the basis of such table. Actual retirements of section 38 property for a taxable year shall be assigned to particular vintage accounts by—

(*a*) Determining the expected retirements for such taxable year from each vintage account containing such section 38 property, and

(*b*) Ratably allocating such actual retirements to each vintage account containing such section 38 property.

However, the unadjusted basis of retired assets assigned to any particular vintage account shall not exceed the unadjusted basis of the property contained in such account.

(3) *Special rules.* (i) Taxpayers who properly determine estimated useful lives under § 1.46-3(e)(3) (ii)(*b*) or (iii)

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may treat such assets as having been disposed of or having ceased to be section 38 assets in the order of the estimated useful lives that were assigned to such assets. Thus, the asset that is first disposed of or first ceases to be section 38 property may be treated as the asset to which there was assigned the shortest estimated useful life; the next asset disposed of or ceasing to be section 38 property may be treated as the asset to which there was assigned the second shortest life, etc.

(ii) In the case of taxpayers who use the rule of subdivision (i) of this subparagraph with respect to mass assets for which the estimated useful life was determined under § 1.46-3(e)(3)(iii), if the dispersion shown by the mortality dispersion table effective for a taxable year subsequent to the credit year is the same as the dispersion shown by the mortality table that was effective for the credit year (for example, if the same average useful life on the standard mortality dispersion table reflects the taxpayer's experience for both such years), no recapture determination is required for such subsequent taxable year.

(iii) Notwithstanding subdivision (i) of this subparagraph, taxpayers who, for purposes of determining qualified investment, do not use a mortality dispersion table with respect to certain section 38 assets similar in kind but who consistently assign under paragraph (e)(3)(ii) (*b*) of § 1.46-3 to such assets separate lives based on the estimated range of years taken into consideration in establishing the average useful life of such assets, may select the order in which such assets shall be considered as having been disposed of, regardless of the taxable years in which such assets were placed in service. If a taxpayer uses the method provided in this subdivision to determine that any asset is considered as having been disposed of, then, in addition to complying with the record requirements of subparagraph (1)(i) of this paragraph, such taxpayer must maintain records from which he can establish to the satisfaction of the district director that such asset has not previously been considered as having been disposed of. In addition, if, for any taxable year, a taxpayer uses the method provided in this subdivision for any asset, he must use for such year and for each subsequent taxable year (unless he obtains the district director's consent to change) with respect to all assets similar in kind to such asset—

(*a*) The method of determining estimated useful lives described in paragraph (e)(3)(ii)(b) of § 1.46-3, and

(*b*) The method he has selected under this subdivision for determining the order in which such assets are considered as having been disposed of.

A request by a taxpayer to obtain the district director's consent to change a system or method described in this subdivision with respect to assets similar in kind must be submitted to the district director on or before the last day of the taxable year with respect to which the change is sought.

(iv) Notwithstanding subdivisions (i), (ii), and (iii) of this subparagraph, there shall be taken into account separately any abnormal retirement of section 38 property of substantial value for which the estimated useful life was determined under § 1.46-3(e)(3) (ii)(*b*) or (iii). For definition of abnormal retirement, see paragraph (b) of § 1.167(a)-8.

(4) *Definition of "mass assets".* For purposes of this paragraph and paragraph (e)(3)(iii) of § 1.46-3, the term "mass assets" means a mass or group of individual items of property (i) not necessarily homogeneous, (ii) each of which is minor in value relative to the total value of such mass or group, (iii) numerous in quantity, (iv) usually accounted for only on a total dollar or quantity basis, and (v) with respect to which separate identification is impracticable. The term includes portable air and electric tools, jigs, dies, railroad ties, overhead conductors, hardware, textile spindles, and minor items of office, plant, and store furniture and fixtures; and returnable containers and other items which are considered subsidiary assets for purposes of computing the allowance for depreciation.

(5) *Example.* This paragraph may be illustrated by the following example:

Example. (i) Taxpayer A uses numerous small returnable containers in his business.

It is impracticable for A to keep individual detailed records with respect to such containers which are mass assets. In 1965, A places in service 10 million containers purchased for $1 million, and reasonably determines that each of such containers has a basis of 10 cents. A places such containers in a multiple asset account to which is assigned a 5-year average useful life for purposes of computing depreciation. A has conducted an appropriate mortality study which shows that the containers have the following estimated useful lives:

Percent of assets	Useful life (years)
10	3
20	6
40	5
20	6
10	7

A assigns separate lives to such assets based on the estimated range of years taken into account in establishing the average useful life of such containers. The qualified investment with respect to such containers is $400,000 computed as follows:

Useful life	Basis	Applicable percentage	Qualified investment
4	$200,000	33⅓	$66,666
5	400,000	33⅓	133,334
6	200,000	66⅔	133,334
7	100,000	66⅔	66,666
			400,000

A's credit earned for 1965 of $28,000 (7 percent times $400,000) is allowed as a credit under section 38 against A's liability for tax of $2 million. (For purposes of this example the computations of investment credit and recapture with respect to containers placed in service in years other than 1965 are omitted.) The mortality studies effective for 1966 and 1967 show that none of the containers placed in service in 1965 was retired.

(ii) A's mortality study effective with respect to 1968 shows that the containers are being retired as follows:

Percent of assets	Useful life (years)
30	3
20	4
30	5
10	6
10	7

Thus, the 1968 study shows that 30 percent of the 10 million containers placed in service in 1965 were retired in 1968. Under the rule of subparagraph (3)(i) of this paragraph, the 3 million containers are treated as consisting of the 1 million containers to which was assigned a 3-year useful life and the 2 million containers to which was assigned a 4-year useful life. Taking into account only the fact that 30 percent of the containers placed in service in 1965 had an actual life of less than 4 years, A's recomputed qualified investment for 1965 is $333,333 and his recomputed credit earned is $23,333. A's income tax for 1968 is increased by $4,667 ($28,000 original credit earned minus $23,333 recomputed credit earned).

(iii) The mortality study effective for 1969 shows the same results as the mortality study effective for 1968. Thus, it shows that 2 million containers were retired in 1969 (an actual life of 4 years). Under the rule of subparagraph (3)(i) of this paragraph such 2 million containers are treated as having been among 4 million containers to which were assigned a 5-year useful life. Therefore, no recapture determination is required for 1969.

(iv) The mortality study effective for 1970 shows the same results as the mortality study effective for 1968. Thus, it shows that 3 million containers were retired in 1970 (an actual life of 5 years). Under the rule of subparagraph (3)(i) of this paragraph, the 3 million are treated as having been assigned useful lives as follows: 2 million as having been assigned a useful life of 5 years, and 1 million as having been assigned a useful life of 6 years. Taking into account only the fact that 10 percent of the containers placed in service in 1965 had an actual life of 5 years rather than the 6 years estimated useful life assigned to them, A's recomputed qualified investment is $300,000 and A's credit earned for 1965 is $21,000. Thus, taking into account the 1968 recapture determination A's income tax for 1970 is increased by $2,333.

(f) *Public utility property*—(1) *Recomputed qualified investment.* In recomputing qualified investment with respect to section 38 property which becomes public utility property (as defined in paragraph (g) of § 1.46-3)—

(i) If such property becomes public utility property less than 3 years from the date on which it was placed in service, then such property shall be treated as public utility property for its entire useful life.

(ii) If such property becomes public utility property 3 years or more but less than 5 years from the date on which it was placed in service, then such property shall be treated as section 38 property which is not public

utility property for the first 3 years of its estimated useful life and as public utility property for the remaining period of its estimated useful life.

(iii) If such property becomes public utility property 5 years or more but less than 7 years from the date on which it was placed in service, then such property shall be treated as section 38 property which is not public utility property for the first 5 years of its estimated useful life and as public utility property for the remaining period of its estimated useful life.

If property becomes public utility property before August 16, 1971, this subparagraph shall be applied by substituting "4 years" for "3 years", "6 years" for "5 years", and "8 years" for "7 years".

(2) *Examples.* Subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). (i) X Corporation, which makes its returns on the basis of the calendar year, acquired and placed in service on January 1, 1969, an item of section 38 property with a basis of $12,000 and an estimated useful life of 8 years. The amount of qualified investment with respect to such property was $12,000. For the taxable year 1969, X Corporation's credit earned was $840 (7 percent of $12,000) and for such taxable year X Corporation was allowed under section 38 a credit of $840 against its liability for tax. During the taxable year 1972 such property becomes public utility property (as defined in paragraph (g) of § 1.46-3) with respect to X Corporation.

(ii) Such item of section 38 property is treated as section 38 property which is not public utility property for the first 3 years of its 8-year estimated useful life and is treated as public utility property for the remaining 5 years. The recomputed qualified investment with respect to such item of section 38 property is $7,428, computed as follows:

$12,000 basis × 33⅓ percent applicable percentage	$4,000
$12,000 basis × ⅔ × 66⅔ percent applicable percentage	3,428
Total recomputed qualified investment	7,428

X Corporation's recomputed credit earned for the taxable year 1969 is $520 (7 percent of $7,428). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1972 is increased by the $320 decrease in its credit earned for the taxable year 1969 (that is, $840 original credit earned minus $520 recomputed credit earned).

Example (2). (i) The facts are the same as in example (1) and in addition the item of section 38 property which became public utility property in 1972 is sold to Y Corporation on January 2, 1975.

(ii) The actual useful life of such item of property is 6 years. For the first 3 years of its 8-year estimated useful life such item is treated as section 38 property which is not public utility property and for the remaining 3 years is treated as public utility property. The recomputed qualified investment with respect to such item of property is $5,714, computed as follows:

$12,000 basis × 33⅓ percent applicable percentage	$4,000
$12,000 basis × ⅔ × 33⅓ percent applicable percentage	1,714
Total recomputed qualified investment	5,714

X Corporation's recomputed credit earned for the taxable year 1969 is $400 (7 percent of $5,714). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1975 is increased by $120 (that is, $440 ($840 original credit earned minus $400 recomputed credit earned) minus $320 increase in tax for 1969).

(g) *Special rules for progress expenditure property.* [Reserved]

(h) *Special rules for energy property*—(1) *In general.* A recapture determination is required for the investment credit attributable to the energy percentage (energy credit) if property is (i) disposed of or (ii) otherwise ceases to be energy property (as defined in section 48(l)) with regard to the taxpayer before the close of the estimated useful life (as determined under paragraph (a)(2)(i) of this section) which was taken into account in computing qualified investment.

(2) *Dispositions.* The term "disposition" is described in § 1.47-2(a)(1). A transfer of energy property that is a "disposition" requiring a recapture determination for the investment credit attributable to the regular percentage (regular credit) and the ESOP percentage (ESOP credit) will also be a "disposition" requiring a recapture determination for the energy credit.

(3) *Cessation.* The term "cessation" is described in § 1.47-2(a)(2). For energy property, a cessation occurs during a taxable year if, by reason of a change in use or otherwise, the property would not have qualified for an

energy credit if placed in service during that year. A change in use will not require a recapture determination for the regular or ESOP credit unless, by reason of the change, the property would not have qualified for the regular or ESOP credit if placed in service during that year.

(4) *Recordkeeping requirement.* For recordkeeping requirements with respect to dispositions or cessations, the rules of paragraph (e)(1) of this section apply. For example, the taxpayer must maintain records for each recycling facility indicating the percentage of virgin materials used each year. See, § 1.48-9(g)(5)(ii).

(5) *Examples.* The following examples illustrate this paragraph (h).

Example (1). (a) In 1980, corporation X, a calendar year taxpayer, acquires and places in service a computer that will perform solely energy conserving functions in connection with an existing industrial process. Assume the computer has a 10 year useful life and qualifies for both the regular and energy credits. In 1981, a change is made in the industrial process (within the meaning of § 1.48-9(l)(2)). However, for 1981 the computer continues to perform solely energy conserving functions. In 1982, the computer ceases to perform energy conserving functions and begins to perform a production related function.

(b) For 1981, a recapture determination is not required. For 1982, the entire energy credit must be recaptured, although none of the regular credit is recaptured. If in 1989 the computer first ceased to perform an energy conserving function, no part of the energy credit would be recaptured.

Example (2). Assume the same facts and conclusion as in example (1). Assume further that X sells the computer in 1985. A recapture determination is required for the regular credit.

Example (3). In 1981, corporation Y, a calendar year taxpayer, acquires and places in service recycling equipment. Assume the equipment has a 7-year useful life and qualifies for both the regular credit and energy credit. During the course of 1982, more than 10 percent of the material recycled is virgin material. The energy credit is recaptured in its entirety, although none of the regular credit is recaptured. See § 1.48-9(g)(5)(B)(ii).

Example (4). In 1980, corporation Z, a calendar year taxpayer, acquires and places in service a boiler the primary fuel for which is an alternate substance. The boiler has a 7-year useful life. Assume the boiler is a structural component of a building within the meaning of § 1.48-1(e)(2). Assume further that the boiler is not a part of a qualified rehabilitated building (as defined in section 48(g)(1)) or a single purpose agricultural or horticultural structure (as defined in section 48(p)). Z is allowed only an energy credit since the boiler is a structural component of a building. In 1984, Z modifies the boiler to use oil as the primary fuel. A recapture determination is required for the energy credit. See § 1.48-9(c)(3).

[T.D. 6931, 32 FR 14027, Oct. 10, 1967, as amended by T.D. 7203, 37 FR 17127, Aug. 25, 1972; T.D. 7765, 46 FR 7291, Jan. 23, 1981]

§ 1.47-2 "Disposition" and "cessation".

(a) *General rule*—(1) *"Disposition".* For purposes of this section and § 1.47-1 and §§ 1.47-3 through 1.47-6, the term "disposition" includes a sale in a sale-and-leaseback transaction, a transfer upon the foreclosure of a security interest and a gift, but such term does not include a mere transfer of title to a creditor upon creation of a security interest. See paragraph (g) of § 1.47-3 for treatment of certain sale-and-leaseback transactions.

(2) *"Cessation".* (i) A determination of whether section 38 property ceases to be section 38 property with respect to the taxpayer must be made for each taxable year subsequent to the credit year. Thus, in each such taxable year the taxpayer must determine, as if such property were placed in service in such taxable year, whether such property would qualify as section 38 property (within the meaning of § 1.48-1) in the hands of the taxpayer for such taxable year.

(ii) Section 38 property does not cease to be section 38 property with respect to the taxpayer in any taxable year subsequent to the credit year merely because under the taxpayer's depreciation practice no deduction for depreciation with respect to such property is allowable to the taxpayer for the taxable year, provided that the property continues to be used in the taxpayer's trade or business (or in the production of income) and otherwise qualifies as section 38 property with respect to the taxpayer.

(iii) This subparagraph may be illustrated by the following examples:

Example (1). A, an individual who makes his returns on the basis of the calendar year, on January 1, 1962, acquired and

placed in service in his trade or business an item of section 38 property with an estimated useful life of eight years. On January 1, 1965, A removes the item of section 38 property from use in his trade or business by converting such item to personal use. Therefore no deduction for depreciation with respect to such item of property is allowable to A for the taxable year 1965. On January 1, 1965, such item of property ceases to be section 38 property with respect to A.

Example (2). On January 1, 1965, A placed in service an item of section 38 property with a basis of $10,000 and an estimated useful life of 4 years. A depreciates such item, which has a salvage value of $2,000 (after taking into account section 167(f)), on the declining balance method at a rate of 50 percent (that is, twice the straight line rate of 25 percent). With respect to such item, A is allowed deductions for depreciation of $5,000 for 1965, $2,500 for 1966, and $500 for 1967. A is not allowed a deduction for depreciation for 1968 although he continues to use such item in his trade or business. Such item does not cease to be section 38 property with respect to A in 1968.

(b) *Leased property*—(1) *In general.* For purposes of paragraph (a) of § 1.47-1, generally the mere leasing of section 38 property by a lessor who took the basis of such property into account in computing his qualified investment for the credit year shall not be considered to be a disposition. However, in a case where a lease is treated as a sale for income tax purposes such transaction is considered to be a disposition. Leased section 38 property ceases to be section 38 property with respect to the lessor if, in any taxable year subsequent to the credit year, such property would not qualify as section 38 property (as defined in § 1.48-1) in the hands of the lessor, the lessee, or any sublessee. Thus, if, in a taxable year subsequent to the credit year, a lessee uses the property predominantly outside the United States, such property shall be considered to have ceased to be section 38 property with respect to the lessor.

(2) *Where lessor elects to treat lessee as purchaser.* For purposes of paragraph (a) of § 1.47-1, if, under § 1.48-4, the lessor of new section 38 property made a valid election to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, the following rules apply in determining whether such property is disposed of, or otherwise ceases to be section 38 property with respect to the lessee:

(i) Generally, a mere disposition by the lessor of property subject to a lease shall not be considered to be a disposition by the lessee.

(ii) If the lessor makes a disposition of property subject to a lease to a person who may not, under § 1.48-4, make a valid election to treat the lessee as having purchased such property for purposes of the credit allowed by section 38 (such as a person described in paragraph (a)(5) of § 1.48-4), such property shall be considered to have ceased to be section 38 property with respect to the lessee on the date of such disposition.

(iii) If a lease is terminated and the property is transferred by the lessee to the lessor or to any other person, such transfer shall be considered to be a disposition by the lessee.

(iv) If the lessee actually purchases such property in the credit year or in a taxable year subsequent to the credit year, such purchase shall not be considered to be a disposition.

(v) The property ceases to be section 38 property with respect to the lessee if in any taxable year subsequent to the credit year such property would not qualify as section 38 property (as defined in § 1.48-1) in the hands of the lessor, the lessee, or any sublessee. Thus, for example, if, in a taxable year subsequent to the credit year, a sublessee uses the property predominantly outside the United States, the property ceases to be section 38 property with respect to the lessee.

(c) *Reduction in basis of section 38 property*—(1) *General rule.* If, in the credit year or in any taxable year subsequent to the credit year, the basis (or cost) of section 38 property is reduced, for example, as a result of a refund of part of the cost of the property, then such section 38 property shall be treated as having ceased to be section 38 property with respect to the taxpayer to the extent of the amount of such reduction in basis (or cost) on the date the refund which results in such reduction in basis (or cost) is received or accrued, except that for purposes of § 1.47-1(a) the actual useful life of the property treated as having

ceased to be section 38 property shall be considered to be less than 3 years.

(2) *Example.* Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. (i) On January 1, 1962, A, a cash basis taxpayer, acquired from X Cooperative an item of section 38 property with a basis of $100 and an estimated useful life of 10 years which he placed in service on such date. The amount of qualified investment with respect to such asset was $100. For the taxable year 1962 A was allowed under section 38 a credit of $7 against his liability for tax. On June 1, 1963, A receives a $10 patronage dividend from X Cooperative with respect to such asset. Under paragraph (c)(2)(i) of § 1.1385-1, the basis of the asset in A's hands is reduced by $10.

(ii) Under subparagraph (1) of this paragraph, on June 1, 1963, the item of section 38 property ceases to be section 38 property with respect to A to the extent of $10 of the original $100 basis.

(d) *Retirements.* A retirement of section 38 property, including a normal retirement (as defined in paragraph (b) of § 1.167(a)-8, relating to definition of normal and abnormal retirements), whether from a single asset account or a multiple asset account, and an abandonment, are dispositions for purposes of paragraph (a) of § 1.47-1.

(e) *Conversion of section 38 property to personal use.* (1) If, for any taxable year subsequent to the credit year—

(i) A deduction for depreciation is allowable to the taxpayer with respect to only a part of section 38 property because such property is partially devoted to personal use, and

(ii) The part of the property (expressed as a percentage of its total basis (or cost)) with respect to which a deduction for depreciation is allowable for such taxable year is less than the part of the property with respect to which a deduction for depreciation was allowable in the credit year,

then such property shall be considered as having ceased to be section 38 property with respect to the taxpayer to such extent. Further, property ceases to be section 38 property with respect to the taxpayer to the extent that a deduction for depreciation thereon is disallowed under section 274 (relating to disallowance of certain entertainment, etc., expenses).

(2) *Examples.* Subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). (i) A, a calendar-year taxpayer, acquired and placed in service on January 1, 1962, an automobile with a basis of $2,400 and an estimated useful life of four years. In the taxable year 1962 the automobile was used by A 80 percent of the time in his trade or business and was used 20 percent of the time for personal purposes. Thus, for the taxable year 1962 only 80 percent of the basis of the automobile qualified as section 38 property since a deduction for depreciation was allowable to A only with respect to 80 percent of the basis of the automobile. In the taxable year 1963 the automobile is used by A only 60 percent of the time in his trade or business. Thus, for the taxable year 1963 a deduction for depreciation is allowable to A only with respect to 60 percent of the basis of the automobile.

(ii) Under subparagraph (1) of this paragraph, on January 1, 1963, the automobile ceases to be section 38 property with respect to A to the extent of 20 percent (80 percent minus 60 percent) of the $2,400 basis of the automobile.

Example (2). (i) The facts are the same as in example (1) and in addition for the taxable year 1964 a deduction for depreciation is allowable to A only with respect to 40 percent of the basis of the property.

(ii) Under subparagraph (1) of this paragraph, on January 1, 1964, the automobile ceases to be section 38 property with respect to A to the extent of 20 percent (60 percent minus 40 percent) of the $2,400 basis of the automobile.

[T.D. 6931, 32 FR 14032, Oct. 10, 1967, as amended by T.D. 7203, 37 FR 17128, Aug. 25, 1972]

§ 1.47-3 Exceptions to the application of § 1.47-1.

(a) *In general.* Notwithstanding the provisions of § 1.47-2, relating to "disposition" and "cessation," paragraph (a) of § 1.47-1 shall not apply if paragraph (b) of this section (relating to transfers by reason of death), paragraph (c) of this section (relating to property destroyed by casualty), paragraph (d) of this section (relating to reselection of used section 38 property), paragraph (e) of this section (relating to transactions to which section 381(a) applies), paragraph (f) of this section (relating to mere change in form of conducting a trade or business), paragraph (g) of this section (relating to sale-and-leaseback transac-

tions), or paragraph (h) of this section (relating to certain property replaced after Apr. 18, 1969) applies with respect to such disposition or cessation.

(b) *Transfers by reason of death*— (1) *General rule.* Notwithstanding the provisions of § 1.47-2, relating to "disposition" and "cessation", paragraph (a) of § 1.47-1 shall not apply to a transfer of section 38 property by reason of the death of the taxpayer. Thus, for example, with respect to section 38 property held in joint tenancy, paragraph (a) of § 1.47-1 shall not apply to the transfer of the deceased taxpayer's interest to the surviving joint tenant. If, under § 1.48-4, the lessor of new section 38 property made a valid election to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, paragraph (a) of § 1.47-1 does not apply if, by reason of the death of the lessee, there is a termination of the lease and transfer of the leased property to the lessor, or there is an assignment of the lease and transfer of the leased property to another person. Moreover, paragraph (a) of § 1.47-1 does not apply to the transfer of a partner's interest in a partnership, a beneficiary's interest in an estate or trust, or shares of stock of a shareholder of an electing small business corporation (as defined in section 1371(b)) by reason of the death of such partner, beneficiary, or shareholder. Paragraph (a) of § 1.47-1 shall not apply to property prior to his death even if the value of such gift is included in his gross estate for estate tax purposes (such as, a gift in contemplation of death under section 2035). The effect of this subparagraph is that any section 38 property held by a taxpayer at the time of his death is deemed to have been held by him for its entire estimated useful life.

(2) *Examples.* Subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). (i) A, an individual, acquired and placed in service on January 1, 1962, an item of section 38 property with a basis of $10,000 and an estimated useful life of eight years. On April 28, 1963, A dies and, as a result of A's death, his interest in such item of section 38 property is transferred to a testamentary trust pursuant to A's will, and on February 1, 1967, the trust is terminated and the item of section 38 property is transferred to the beneficiaries of the trust.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the transfer, as a result of A's death, of his interest in such item of section 38 property to the testamentary trust. Moreover, paragraph (a) of § 1.47-1 does not apply to the February 1, 1967, transfer of such item of section 38 property by the trust to its beneficiaries.

Example (2). (i) X Corporation, an electing small business corporation (as defined in section 1371(b)) which makes its returns on the basis of a calendar year, acquired and placed in service during 1962 an item of section 38 property. On December 31, 1962, X Corporation had 10 shares of stock outstanding which were owned as follows: A owned eight shares and B owned two shares. On December 31, 1962, 80 percent of the basis of the item of section 38 property was apportioned to A and 20 percent to B. On June 1, 1964, A dies and, as a result of A's death, his eight shares of stock in X Corporation are transferred to his wife. On July 10, 1965, X Corporation sells the item of section 38 property to Y Corporation.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the transfer, as a result of A's death, of his eight shares of stock in X Corporation to his wife. Moreover, with respect to the July 10, 1965, sale paragraph (a) of § 1.47-1 applies only to the 20 percent of the basis of the item of section 38 property which was apportioned to B.

(c) *Property destroyed by casualty*— (1) *Dispositions after April 18, 1969.* Notwithstanding the provisions of § 1.47-2, relating to "disposition" and "cessation", paragraph (a) of § 1.47-1 shall not apply to property which, after April 18, 1969, and before August 16, 1971, is disposed of or otherwise ceases to be section 38 property with respect to the taxpayer on account of its destruction or damage by fire, storm, shipwreck, or other casualty, or by reason of its theft.

(2) *Dispositions before April 19, 1969.* (i) In the case of property which, before April 19, 1969, is disposed of or otherwise ceases to be section 38 property with respect to the taxpayer on account of its destruction or damage by fire, storm, shipwreck or other casualty, or by reason of its theft, paragraph (a) of § 1.47-1 shall apply except to the extent provided in subdivisions (ii) and (iii) of this subparagraph.

(ii) Paragraph (a) of § 1.47-1 shall not apply if—

(*a*) Section 38 property is placed in service by the taxpayer to replace (within the meaning of paragraph (h) of § 1.46-3) the destroyed, damaged, or stolen property, and

(*b*) The basis (or cost) of the section 38 property which is placed in service by the taxpayer to replace the destroyed, damaged, or stolen property is reduced under paragraph (h) of § 1.46-3.

(iii) If property which would be section 38 property but for section 49 is placed in service by the taxpayer to replace the destroyed, damaged, or stolen property, then the provisions of paragraph (h) of this section (other than the requirement that the replacement take place within 6 months after the disposition) shall apply.

(3) *Examples.* The provisions of subparagraph (2)(ii) of this paragraph may be illustrated by the following examples:

Example (1). (i) A acquired and placed in service on January 1, 1962, machine No. 1 which qualified as section 38 property with a basis of $30,000 and an estimated useful life of 6 years. The amount of qualified investment with respect to such machine was $20,000. For the taxable year 1962 A's credit earned of $1,400 was allowed under section 38 as a credit against its liability for tax. On January 1, 1963, machine No. 1 is completely destroyed by fire. On January 1, 1963, the adjusted basis of machine No. 1 in A's hands is $24,500. A receives $23,000 in insurance proceeds as compensation for the destroyed machine, and on February 15, 1964, A acquires and places in service machine No. 2, which qualifies as section 38 property, with a basis of $41,000 and an estimated useful life of 6 years to replace machine No. 1.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of § 1.47-1 does not apply with respect to machine No. 1 since machine No. 2 is placed in service to replace machine No. 1 and the $41,000 basis of machine No. 2 is reduced, under paragraph (h) of § 1.46-3, by $23,000. (See example (1) of paragraph (h)(3) of § 1.46-3.)

Example (2). (i) The facts are the same as in example (1) except that A receives only $19,000 in insurance proceeds as compensation for the destroyed machine.

(ii) Although machine No. 2 is placed in service to replace machine No. 1, subparagraph (1) of this paragraph does not apply with respect to machine No. 1 since the basis of machine No. 2 is not reduced under paragraph (h) of § 1.46-3. Paragraph (a) of § 1.47-1 applies with respect to the January 1, 1963, destruction of machine No. 1. The actual useful life of machine No. 1 is 1 year. The recomputed qualified investment with respect to such machine is zero ($30,000 basis multiplied by zero applicable percentage) and A's recomputed credit earned for the taxable year 1962 is zero. The income tax imposed by chapter 1 of the Code on A for the taxable year 1963 is increased by $1,400.

(d) *Reselection of used section 38 property*—(1) *Reselection.* If—

(i) Used section 38 property (as defined in § 1.48-3) the cost of which was taken into account in computing the taxpayer's qualified investment is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing such qualified investment, and

(ii) For the taxable year in which the property described in subdivision (i) of this subparagraph was placed in service, the sum of (*a*) the cost of used section 38 property placed in service by the taxpayer, and (*b*) the cost of used section 38 property apportioned to such taxpayer exceeded $50,000,

then such taxpayer may treat the cost of any used section 38 property (regardless of its estimated useful life) which was not originally selected, under paragraph (c)(4) of § 1.48-3, to be taken into account in computing qualified investment for such taxable year (or previously reselected under this subparagraph) as having been selected (in accordance with the principles of paragraph (c)(4)(ii) of § 1.48-3) in place of the cost of the used section 38 property described in subdivision (i) of this subparagraph. Hereinafter such reselected property is referred to as "newly selected used section 38 property". For purposes of this subparagraph, the cost of used section 38 property apportioned to a taxpayer means the sum of the cost of used section 38 property apportioned to him by a trust, estate, or electing small business corporation (as defined in section 1371(b)), and his share of the cost of partnership used section 38 property, with respect to the taxable year of such trust, estate, corporation or partnership ending with or within such

taxpayer's taxable year. In the case of a taxpayer to whom paragraph (c)(2) of § 1.48-3 applied for the taxable year in which the property described in subdivision (i) of this subparagraph was placed in service, a $25,000 amount shall be substituted for the $50,000 amount referred to in subdivision (ii)(*b*) of this subparagraph, and in the case of a member of an affiliated group (as defined in subparagraph (6) of § 1.48-3(e)) the amount apportioned to such member under paragraph (e) of § 1.48-3 shall be substituted for such $50,000 amount.

(2) *Application of paragraph (a) of § 1.47-1.* (i) If a taxpayer treats, under subparagraph (1) of this paragraph, the cost of any used section 38 property which was not originally selected as having been selected in place of the cost of used section 38 property described in subparagraph (1)(i) of this paragraph, then, not withstanding the provisions of § 1.47-2 (relating to "disposition" and "cessation"), paragraph (a) of § 1.47-1 shall not apply to the property described in subparagraph (1)(i) of this paragraph to the extent of the cost of the newly selected used section 38 property.

(ii) If the cost of the used section 38 property described in subparagraph (1)(i) of this paragraph exceeds the cost of the newly selected used section 38 property, then the property described in subparagraph (1)(i) of this paragraph shall cease to be section 38 property with respect to the taxpayer to the extent of such excess.

(iii) If the newly selected used section 38 property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life of the property described in subparagraph (1)(i) of this paragraph, then, unless he reselects other used section 38 property, paragraph (a) of § 1.47-1 shall apply with respect to such newly selected used section 38 property. For purposes of recomputing qualified investment with respect to such newly selected used section 38 property the actual useful life shall be deemed to be the period beginning with the date on which the property described in subparagraph (1)(i) of this paragraph was placed in service by the taxpayer and ending with the date of the disposition or cessation with respect to such newly selected used section 38 property. See paragraph (c) of § 1.47-1, relating to date placed in service and date of disposition or cessation.

(3) *Information requirement.* (i) If in any taxable year this paragraph applies to a taxpayer, such taxpayer shall attach to his income tax return for such taxable year a statement containing the information required by subdivision (ii) of this subparagraph.

(ii) The statement referred to in subdivision (i) of this subparagraph shall contain the following information:

(*a*) The taxpayer's name, address and taxpayer account number; and

(*b*) With respect to the originally selected used section 38 property and the newly selected used section 38 property, the month and year placed in service, cost, and estimated useful life.

(4) *Examples.* This paragraph may be illustrated by the following examples:

Example (1). (i) X Corporation purchased and placed in service on January 1, 1962, machines No. 1 and No. 2, which qualified as used section 38 property, each with a cost of $50,000 and an estimated useful life of eight years. The aggregate cost of used section 38 property taken into account by X Corporation in computing its qualified investment for the taxable year 1962 could not exceed $50,000; therefore, under paragraph (c)(4) of § 1.48-3, X selected the $50,000 cost of machine No. 1 to be taken into account in computing its qualified investment for the taxable year 1962. The qualified investment with respect to machine No. 1 was $50,000. For the taxable year 1962 X's credit earned of $3,500 was allowed under section 38 as a credit against its liability for tax. On January 2, 1965, X Corporation sells machine No. 1 to Y Corporation.

(ii) Under subparagraph (1) of this paragraph, X Corporation treats the $50,000 cost of machine No. 2 as having been selected to be taken into account in computing its qualified investment for the taxable year 1962 in place of the $50,000 cost of machine No. 1. Therefore, under subparagraph (2)(i) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the January 2, 1965, disposition of machine No. 1.

Example (2). (i) The facts are the same as in example (1) and in addition X Corporation, on December 2, 1966, sells machine No. 2 to Z Corporation.

(ii) Under subparagraph (2)(iii) of this paragraph, paragraph (a) of § 1.47-1 applies with respect to the December 2, 1966, disposition of machine No. 2. The actual useful life of machine No. 2 is four years and eleven months (that is, the period beginning on January 1, 1962, and ending on December 2, 1966). The recomputed qualified investment with respect to machine No. 2 is $16,667 ($50,000 cost multiplied by 33⅓ percent applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is $1,167. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1966 is increased by the $2,333 decrease in its credit earned for the taxable year 1962 (that is, $3,500 original credit earned minus $1,167 recomputed credit earned).

Example (3). (i) The facts are the same as in example (1) except that machine No. 2 had a cost of $30,000.

(ii) Under subparagraph (1) of this paragraph, X Corporation treats the $30,000 cost of machine No. 2 as having been selected to be taken into account in computing its qualified investment for the taxable year 1962 in place of the $50,000 cost of machine No. 1. Therefore, under subparagraph (2)(i) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the January 2, 1965, disposition of machine No. 1 to the extent of $30,000 of the $50,000 cost of machine No. 1. However, under subparagraph (2)(ii) of this paragraph, paragraph (a) of § 1.47-1 applies to the January 2, 1965, disposition of machine No. 1 to the extent of $20,000 (that is, $50,000 cost of machine No. 1 minus $30,000 cost of machine No. 2). The actual useful life of such $20,000 portion of machine No. 1 is three years (that is, the period beginning on January 1, 1962, and ending on January 2, 1965). The recomputed qualified investment with respect to the $20,000 portion of the cost of machine No. 1 is zero ($20,000 portion of the cost multiplied by zero applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is $2,100 (7 percent of $30,000). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1965 is increased by the $1,400 decrease in its credit earned for the taxable year 1962 (that is, $3,500 original credit earned minus $2,100 recomputed credit earned).

(e) *Transactions to which section 381(a) applies*—(1) *General rule.* Notwithstanding the provisions of § 1.47-2, relating to "disposition" and "cessation", paragraph (a) of § 1.47-1 shall not apply to a disposition of section 38 property in a transaction to which section 381(a) (relating to carryovers in certain corporate acquisitions) applies. If the section 38 property described in the preceding sentence is disposed of, or otherwise ceases to be section 38 property with respect to the acquiring corporation, before the close of the estimated useful life which was taken into account in computing the transferor corporation's qualified investment, then paragraph (a) of § 1.47-1 shall apply to the acquiring corporation with respect to such section 38 property. For purposes of recomputing qualified investment with respect to such property its actual useful life shall be the period beginning with the date on which it was placed in service by the transferor corporation and ending with the date of the disposition by, or cessation with respect to, the acquiring corporation.

(2) *Examples.* This paragraph may be illustrated by the following examples:

Example (1). (i) X Corporation, a wholly owned subsidiary of Y Corporation, acquired and placed in service on January 1, 1962, an item of section 38 property with a basis of $12,000 and an estimated useful life of eight years. Both X and Y make their returns on the basis of a calendar year. The qualified investment with respect to such item was $12,000. For the taxable year 1962 X Corporation's credit earned of $840 was allowed under section 38 as a credit against its liability for tax. On January 15, 1967, X Corporation is liquidated under section 332 and all of its properties, including the item of section 38 property, are transferred to Y Corporation. The bases of the properties in the hands of Y Corporation are determined under section 334(b)(1).

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the January 15, 1967, transfer to Y Corporation.

Example (2). (i) The facts are the same as in example (1) and in addition on February 2, 1968, Y Corporation sells the item of section 38 property to Z Corporation.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the January 15, 1967, transfer to Y Corporation. However, paragraph (a) of § 1.47 applies to the February 2, 1968, sale of the property by Y Corporation. The actual useful life of the property is six years and one month (that is, the period beginning on January 1, 1962, and ending on February 2, 1968).

(f) *Mere change in form of conducting a trade or business*—(1) *General rule.* (i) Notwithstanding the provisions of § 1.47-2, relating to "disposi-

tion" and "cessation", paragraph (a) of § 1.47-1 shall not apply to section 38 property which is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing the taxpayer's qualified investment by reason of a mere change in the form of conducting the trade or business in which such section 38 property is used provided that the conditions set forth in subdivision (ii) of this subparagraph are satisfied.

(ii) The conditions referred to in subdivision (i) of this subparagraph are as follows:

(*a*) The section 38 property described in subdivision (i) of this subparagraph is retained as section 38 property in the same trade or business,

(*b*) The transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the partner, beneficiary, or shareholder) of such section 38 property retains a substantial interest in such trade or business,

(*c*) Substantially all the assets (whether or not section 38 property) necessary to operate such trade or business are transferred to the transferee to whom such section 38 property is transferred, and

(*d*) The basis of such section 38 property in the hands of the transferee is determined in whole or in part by reference to the basis of such section 38 property in the hands of the transferor. This subparagraph shall not apply to the transfer of section 38 property if paragraph (e) of this section, relating to transactions to which section 381 applies, applies with respect to such transfer.

(2) *Substantial interest.* For purposes of this paragraph, a transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the partner, beneficiary, or shareholder) shall be considered as having retained a substantial interest in the trade or business only if, after the change in form, his interest in such trade or business—

(i) Is substantial in relation to the total interest of all persons, or

(ii) Is equal to or greater than his interest prior to the change in form.

Thus, where a taxpayer owns a 5-percent interest in a partnership, and, after the incorporation of that partnership, the taxpayer retains at least a 5-percent interest in the corporation, the taxpayer will be considered as having retained a substantial interest in the trade or business as of the date of the change in form.

(3) *Property held for the production of income.* Subparagraph (1)(i) of this paragraph applies to section 38 property held for the production of income (within the meaning of section 167(a)(2)) as well as to section 38 property used in a trade or business.

(4) *Leased property.* In a case where a lessor of new section 38 property made a valid election, under § 1.48-4, to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, in determining whether subparagraph (1)(i) of this paragraph applies to an assignment of the lease and transfer of possession of such property, the condition contained in subparagraph (1)(ii) (*d*) of this paragraph is not applicable.

(5) *Disposition or cessation.* (i) If section 38 property described in subparagraph (1)(i) of this paragraph is disposed of by the transferee, or otherwise ceases to be section 38 property with respect to the transferee, before the close of the estimated useful life which was taken into account in computing the qualified investment of the transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the qualified investment of the partners, beneficiaries, or shareholders) then under paragraph (a) of § 1.47-1 such property ceases to be section 38 property with respect to the transferor (or such partners, beneficiaries, or shareholders), and a recapture determination shall be made with respect to such property. For purposes of recomputing qualified investment with respect to such property, the actual useful life shall be the period beginning with the date on which it was placed in service by the transferor and ending with the date of the dispo-

sition by, or cessation with respect to, the transferee.

(ii) If in any taxable year the transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the partner, beneficiary, or shareholder) of the section 38 property described in subparagraph (1)(i) of this paragraph does not retain a substantial interest in the trade or business directly or indirectly (through ownership in other entities provided that such other entities' bases in such interest are determined in whole or in part by reference to the basis of such interest in the hands of the transferor) then, under paragraph (a) of § 1.47-1, such property ceases to be section 38 property with respect to the transferor and he (or the partner, beneficiary, or shareholder) shall make a recapture determination. For purposes of recomputing qualified investment with respect to property described in this subdivision, its actual useful life shall be the period beginning with the date on which it was placed in service by the transferor and ending with the first date on which the transferor (or the partner, beneficiary, or shareholder) does not retain a substantial interest in the trade or business. Any taxpayer who seeks to establish his interest in a trade or business under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in such trade or business after any such transfer or transfers.

(iii) In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determinations with respect to the transferor in connection with the same property.

(iv) Notwithstanding subparagraph (1) of this paragraph and subdivision (ii) of this subparagraph in the case of a mere change in the form of a trade or business, if the interest of a taxpayer in the trade or business is reduced but such taxpayer has retained a substantial interest in such trade or business, paragraph (a)(2) of § 1.47-4 (relating to electing small business corporations), paragraph (a)(2) of § 1.47-5 (relating to estates or trusts) or paragraph (a)(2) of § 1.47-6 (relating to partnerships) shall apply, as the case may be.

(6) *Examples.* This paragraph may be illustrated by the following examples in each of which it is assumed that the transfer satisfies the conditions of subparagraph (1)(ii) (*a*), (*c*), and (*d*) of this paragraph.

Example (1). (i) On January 1, 1962, A, an individual, acquired and placed in service in his sole proprietorship an item of section 38 property with a basis of $12,000 and an estimated useful life of eight years. The qualified investment with respect to such item was $12,000. For the taxable year 1962 A's credit earned of $840 was allowed under section 38 as a credit against his liability for tax. On March 15, 1963, A transfers all of the assets used in his sole proprietorship to X Corporation, a newly formed corporation, in exchange for 45 percent of the stock of X Corporation.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the March 15, 1963, transfer to X Corporation.

Example (2). (i) The facts are the same as in example (1) and in addition on February 2, 1964, X Corporation sells the item of section 38 property to Y Corporation.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the March 15, 1963, transfer to X Corporation. However, under subparagraph (5)(i) of this paragraph, paragraph (a) of § 1.47-1 applies to the February 2, 1964, sale of the item of section 38 property by X Corporation to Y Corporation. The actual useful life of the property is two years and one month (that is, the period beginning on January 1, 1962, and ending on February 2, 1964). The recomputed qualified investment with respect to such property is zero ($12,000 basis multiplied by zero applicable percentage) and A's recomputed credit earned for the taxable year 1962 is zero. The income tax imposed by chapter 1 of the Code on A for 1964 is increased by the $840 decrease in his credit earned for the taxable year 1962 (that is, $840 credit earned minus zero recomputed credit earned).

Example (3). (i) On January 1, 1962, partnership ABC, which makes its returns on the basis of a calendar year, acquired and placed in service on item of section 38 property with a basis of $20,000 and an estimated useful life of eight years. Partnership ABC has 10 partners who make their returns on the basis of a calendar year and share partnership profits equally. Each partner's share of the basis of such item of section 38 property is 10 percent, that is, $2,000. On March 15, 1963, partnership ABC

transfers all of the assets used in its trade or business to the X Corporation, a newly formed corporation, in exchange for all of the stock of X Corporation and immediately thereafter transfers 10 percent of such stock to each of the 10 partners.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the March 15, 1963 transfer by the ABC Partnership to X Corporation.

Example (4). (i) The facts are the same as in example (3) except that partnership ABC transfers 10 percent of the stock in X Corporation to each of 8 partners, 20 percent to partner A, and cash to partner B.

(ii) Under subparagraph (1)(i) of this paragraph, with respect to all of the partners (including partner A) except partner B, paragraph (a) of § 1.47-1 does not apply to the March 15, 1963, transfer by the ABC Partnership to X Corporation. Paragraph (a) of § 1.47-1 applies with respect to partner B's $2,000 share of the item of section 38 property. See paragraph (a)(1) of § 1.47-6.

Example (5). (i) X Corporation operates a manufacturing business and a separate personal service business. On January 1, 1962, X acquired and placed in service a truck, which qualified as section 38 property, in its manufacturing business. The truck had a basis of $10,000 and an estimated useful life of 8 years. On February 10, 1965, X transfers all the assets used in its manufacturing business to Partnership XY in exchange for a 50-percent interest in such partnership.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the February 10, 1965, transfer to Partnership XY.

(g) *Sale-and-leaseback transactions.* Notwithstanding the provisions of § 1.47-2, relating to "disposition" and "cessation", paragraph (a) of § 1.47-1 shall not apply where section 38 property is disposed of and as part of the same transaction is leased back to the vendor even though gain or loss is recognized to the vendor-lessee and the property ceases to be subject to depreciation in his hands. If paragraph (a) of § 1.47-1 applies with respect to such property subsequent to the transaction, the actual useful life shall begin with the date on which such property was first placed in service by the vendor-lessee as owner.

(h) *Certain property replaced after April 18, 1969*—(1) *In general.* (i) If section 38 property is disposed of and property which is, for purposes of section 1033 and the regulations thereunder, similar or related in service or use to the property disposed of and which would be section 38 property but for the application of section 49 is placed in service to replace the property disposed of, the increase in income tax and adjustment of investment credit carryovers and carrybacks resulting from the recomputation under paragraph (a) of § 1.47-1 shall be reduced (but not below zero) by the credit that would be allowed for the qualified investment of the replacement property (determined as if such property were section 38 property). The preceding sentence shall not apply unless the replacement takes place within 6 months after the disposition. If property otherwise qualifies as replacement property, it is immaterial that it is placed in service (for example, to undergo testing) before the replaced property is disposed of. The assignment by the taxpayer in his return of an estimated useful life to the replacement property in computing its qualified investment will be considered a representation by the taxpayer that he expects to retain the replacement property for its entire estimated useful life. If such property is disposed of before the end of such life, then the circumstances surrounding the replacement will be examined to determine whether the taxpayer's representation was in good faith and, if appropriate, the qualified investment of the replacement property will be recomputed for the year of replacement using the actual useful life of such property.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. On January 1, 1967, A, a calendar year taxpayer, acquired and placed in service a new machine with a basis of $100 and an estimated useful life of 8 years. A's qualified investment was $100 and his credit earned was $7, which was allowed as a credit against tax for 1967. On January 15, 1971, A disposed of the machine and replaced it with a similar new machine costing $75 and having an estimated useful life of 8 years. The new machine would be section 38 property but for section 49. Since the actual useful life of the original machine was at least 4 but less than 6 years, the recomputed qualified investment of the machine is $33.33 (33⅓ percent of $100) and under paragraph (a) of § 1.47-1 the amount of re-

capture tax would be $4.67 ($7, the original credit earned, minus $2.33, the recomputed credit earned). However, under the provisions of this paragraph, the recapture tax is reduced (but not below zero) by the credit that would be allowed for the replacement property (determined as if such property were section 38 property). Under these facts the recapture tax is zero ($4.67, the recapture tax with respect to the original machine, minus $5.25, the credit that would be allowed on the new machine).

(2) *Leased property.* Property disposed of may be replaced with property leased from another, provided (i) an election with respect to the newly leased property could be made under section 48(d) but for section 49, and (ii) the lessee obtains the lessor's written statement that he will not claim such property as replacement property under this paragraph. The statement of the lessor shall contain the information specified in subdivisions (i) through (vii) of § 1.48-4(f)(1) and the statement (or a copy thereof) shall be retained in the records of the lessor and the lessee for a period of at least 3 years after the property is transferred to the lessee.

[T.D. 6931, 32 FR 14033, Oct. 10, 1967, as amended by T.D. 7126, 36 FR 11192, June 10, 1971; T.D. 7203, 37 FR 17128, Aug. 25, 1972]

§ 1.47-4 Electing small business corporation.

(a) *In general*—(1) *Disposition or cessation in hands of corporation.* If an electing small business corporation (as defined in section 1371(b)) or a former electing small business corporation disposes of any section 38 property (or if any section 38 property otherwise ceases to be section 38 property in the hands of the corporation) before the close of the estimated useful life which was taken into account in computing qualified investment with respect to such property, a recapture determination shall be made with respect to each shareholder who is treated, under § 1.48-5, as a taxpayer with respect to such property. Each such recapture determination shall be made with respect to the pro rata share of the basis (or cost) of such property taken into account by such shareholder in computing his qualified investment. For purposes of each such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the electing small business corporation and ending with the date of the disposition or cessation. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determinations made with respect to the shareholder in connection with the same property. For definition of "recapture determination" see paragraph (a)(1) of § 1.47-1.

(2) *Disposition of shareholder's interest*— (i) If—

(*a*) The basis (or cost) of section 38 property is apportioned, under § 1.48-5, to a shareholder of an electing small business corporation who takes such basis (or cost) into account in computing his qualified investment, and

(*b*) After the end of the shareholder's taxable year in which such apportionment was taken into account and before the close of the estimated useful life of the property, such shareholder's proportionate stock interest in such corporation is reduced (for example, by a sale or redemption, or by the issuance of additional shares) below the percentage specified in subdivision (ii) of this subparagraph,

then, on the date of such reduction such section 38 property ceases to be section 38 property with respect to such shareholder to the extent of the actual reduction in such shareholder's proportionate stock interest. (For example, if $100 of the basis of section 38 property was apportioned to a shareholder and if his proportionate stock interest is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then such property shall be treated as having ceased to be section 38 property to the extent of $50.) Accordingly, a recapture determination shall be made with respect to such shareholder. For purposes of such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the electing small business corporation and ending with the date on which it is treated as having ceased to

be section 38 property with respect to the shareholder. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determination made with respect to the shareholder in connection with the same property.

(ii) The percentage referred to in subdivision (i)(*b*) of this subparagraph is 66⅔ percent of the shareholder's proportionate stock interest in the corporation on the date of the apportionment under § 1.48–5. However, once property has been treated under this subparagraph as having ceased to be section 38 property to any extent the percentage referred to shall be 33⅓ percent of the shareholder's proportionate stock interest in the corporation on the date of the apportionment under § 1.48–5.

(iii) In determining a shareholder's proportionate stock interest in a former electing small business corporation for purposes of this subparagraph, the shareholder shall be considered to own stock in such corporation which he owns directly or indirectly (through ownership in other entities provided such other entities' bases in such stock are determined in whole or in part by reference to the basis of such stock in the hands of the transferor). For example, if A, who owns all of the 100 shares of the outstanding stock of corporation X, a corporation which was formerly an electing small business corporation, transfers on November 1, 1966, 70 shares of X stock to corporation Y in exchange for 90 percent of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own 93 percent of the stock of X, 30 percent directly and 63 percent indirectly (i.e., 90 percent of 70). Any taxpayer who seeks to establish his interest in the stock of a former electing small business corporation under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the corporation after any such transfer or transfers.

(b) *Election of a small business corporation under section 1372*—(1) *General rule.* If a corporation makes a valid election under section 1372 to be an electing small business corporation (as defined in section 1371(b)), then on the last day of the taxable year immediately preceding the first taxable year for which such election is effective, any section 38 property the basis (or cost) of which was taken into account in computing the corporation's qualified investment in taxable years prior to the first taxable year for which the election is effective (and which has not been disposed of or otherwise ceased to be section 38 property with respect to the corporation prior to such last day) shall be considered as having ceased to be section 38 property with respect to such corporation and § 1.47–1 shall apply. However, if the corporation and each of the persons who are shareholders of the corporation on the first day of the first taxable year for which the election under section 1372 is to be effective, or on the date of such election, whichever is later, execute the agreement specified in subparagraph (2) of this paragraph, § 1.47–1 shall not apply to any such section 38 property by reason of the election by the corporation under section 1372.

(2) *Agreement of shareholders and corporation.* (i) The agreement referred to in subparagraph (1) of this paragraph shall be signed by the shareholders and the corporation, and shall recite that, in the event the section 38 property described in subparagraph (1) of this paragraph is later disposed of by, or ceases to be section 38 property with respect to, the corporation during a taxable year of the corporation for which the election under section 1372 is effective, each such signer agrees (*a*) to notify the district director of such disposition or cessation, and (*b*) to be jointly and severally liable to pay to the district director an amount equal to the increase in tax provided by section 47. The amount of such increase shall be determined as if such property had ceased to be section 38 property as of the last day of the taxable year immediately preceding the first taxable year for which the election under section 1372 is effective, except that the actual useful life (within the meaning of paragraph (a) of § 1.47–1) of the

property shall be considered to have ended on the date of the actual disposition by, or cessation in the hands of, the electing small business corporation.

(ii) The agreement shall set forth the name, address, and taxpayer account number of each party and the internal revenue district in which each such party files his or its income tax return for the taxable year which includes the last day of the corporation's taxable year immediately preceding the first taxable year for which the election under section 1372 is effective. The agreement may be signed on behalf of the corporation by any person who is duly authorized. The agreement shall be filed with the district director with whom the corporation files its income tax return for its taxable year immediately preceding the first taxable year for which the election under section 1372 is effective and shall be filed on or before the due date (including extensions of time) of such return. However, if the due date (including extensions of time) of such income tax return is on or before September 1, 1967, the agreement may be filed on or before December 31, 1967. For purposes of the two preceding sentences, the district director may, if good cause is shown, permit the agreement to be filed on a later date.

(c) *Examples.* This section may be illustrated by the following examples in each of which it is assumed that X Corporation, an electing small business corporation which makes its returns on the basis of the calendar year, acquired and placed in service on June 1, 1962, three items of section 38 property. The basis and estimated useful life of each item of section 38 property are as follows:

Asset No.	Basis	Estimated useful life (Years)
1	$30,000	4
2	30,000	6
3	30,000	8

On December 31, 1962, X Corporation had 20 shares of stock outstanding which were owned equally by A and B who make their returns on the basis of a calendar year. Under § 1.48-5, the total bases of section 38 properties was apportioned to the shareholders of X Corporation as follows:

	Useful life category		
	4 to 6 years	6 to 8 years	8 years or more
Total bases	$30,000	$30,000	$30,000
Shareholder A (10/20)	15,000	15,000	15,000
Shareholder B (10/20)	15,000	15,000	15,000

Assuming that during 1962 shareholders A and B did not place in service any section 38 property and that they did not own any interests in other electing small business corporations, partnerships, estates, or trusts, the qualified investment of each shareholder is $30,000, computed as follows:

Basis	Applicable percentage	Qualified investment
$15,000	33⅓	$5,000
$15,000	66⅔	10,000
$15,000	100	15,000
		30,000

For the taxable year 1962, each shareholder's credit earned of $2,100 (7 percent of $30,000) was allowed under section 38 as a credit against his liability for tax.

Example (1). (i) On December 2, 1965, X Corporation sells asset No. 3 to Y Corporation.

(ii) The actual useful life of asset No. 3 is three years and six months. The recomputed qualified investment with respect to each shareholder's share of the basis of asset No. 3 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962 each shareholder's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on each of the shareholders for the taxable year 1965 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

Example (2). (i) On December 3, 1964, shareholder A sells 5 of his 10 shares of stock in X Corporation to C, and on December 3, 1965, A sells his remaining 5 shares of stock to D. In addition, on January 2, 1966, X Corporation sells asset No. 3 to Y Corporation.

(ii) Under paragraph (a)(2) of this section, on December 3, 1964, 50 percent of the share of the basis of each of the three items of section 38 property ceases to be section

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38 property with respect to shareholder A since immediately after the December 3, 1964, sale A's proportionate stock interest in X Corporation is reduced to 50 percent of the proportionate stock interest in X Corporation which he held on December 31, 1962. The actual useful life of the share of the bases of the section 38 properties which cease to be section 38 property with respect to A is two years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1964). A's recomputed qualified investment with respect to such properties is $15,000, computed as follows:

Basis	Applicable percentage	Recomputed qualified investment
$7,500	33⅓	$2,500
$7,500	66⅔	5,000
$7,500	100	7,500
		15,000

For the taxable year 1962 shareholder A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on shareholder A for the taxable year 1964 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

(iii) Under paragraph (a)(2) of this section, on December 3, 1965, the remaining 50 percent of the share of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to shareholder A since immediately after the December 3, 1965, sale A's proportionate stock interest in X Corporation is reduced to zero. The actual useful life of the share of the bases of the section 38 properties which cease to be section 38 property with respect to A is three years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1965). A's recomputed qualified investment with respect to such properties is zero. For the taxable year 1962 shareholder A's recomputed credit earned is zero. The income tax imposed by chapter 1 of the Code on shareholder A for the taxable year 1965 is increased by $1,050 (that is, $2,100 ($2,100 original credit earned minus zero recomputed credit earned) reduced by the $1,050 increase in tax for 1964).

(iv) The actual useful life of asset No. 3 which was sold on January 2, 1966, is three years and seven months. The recomputed qualified investment with respect to B's share of the basis of asset No. 3 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962, B's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on shareholder B for the taxable year 1966 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 ($2,100 original credit earned minus $1,050 recomputed credit earned). The sale of asset No. 3 on January 2, 1966, by X Corporation has no effect on A.

(d) *Termination or revocation of an election under section 1372.* Section 38 property shall not be considered to be disposed of or to have ceased to be section 38 property solely by reason of a termination or revocation of a corporation's election under section 1372.

[T.D. 6931, 32 FR 14035, Oct. 10, 1967]

§ 1.47-5 Estates and trusts.

(a) *In general*—(1) *Disposition or cessation in hands of estate or trust.* If an estate or trust disposes of any section 38 property (or if any section 38 property otherwise ceases to be section 38 property in the hands of the estate or trust) before the close of the estimated useful life which was taken into account in computing qualified investment with respect to such property, a recapture determination shall be made with respect to the estate or trust, and each beneficiary who is treated, under § 1.48-6, as a taxpayer with respect to such property. Each such recapture determination shall be made with respect to the share of the basis (or cost) of such property taken into account by such estate or trust and such beneficiary in computing its or his each such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the estate or trust and ending with the date of the disposition or cessation. In making a recapture determination under this subparagraph with respect to a taxpayer there shall be taken into account any prior recapture determinations made with respect to such taxpayer in connection with the same property. For definition of "recapture determination" see paragraph (a)(1) of § 1.47-1.

(2) *Disposition of interest.* (i) If—

(*a*) The basis (or cost) of section 38 property is apportioned, under § 1.48-6, to an estate or trust which, or to a beneficiary of an estate or trust who,

takes such basis (or cost) into account in computing his qualified investment, and

(*b*) After the date on which such section 38 property was placed in service by the estate or trust and before the close of the estimated useful life of the property, such estate's, trust's, or such beneficiary's proportionate interest in the income of the estate or trust is reduced (for example, by a sale, or by the terms of the estate or trust instrument) below the percentage specified in subdivision (ii) of this subparagraph, then, on the date of such reduction, such section 38 property ceases to be section 38 property with respect to such estate, trust, or beneficiary to the extent of the actual reduction in such estate's, trust's, or beneficiary's proportionate interest in the income of the estate or trust. (For example, if $100 of the basis of section 38 property was apportioned to a beneficiary and if his proportionate interest in the income of the estate or trust is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then such property shall be treated as having ceased to be section 38 property to the extent of $50). Accordingly, a recapture determination shall be made with respect to such estate, trust, or beneficiary. For purposes of such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the estate or trust and ending with the date on which it is treated as having ceased to be section 38 property with respect to the estate, trust, or beneficiary. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determination made with respect to the estate, trust, or beneficiary in connection with the same property.

(ii) The percentage referred to in subdivision (i)(*b*) of this subparagraph is 66⅔ percent of the estate's, trust's, or beneficiary's proportionate interest in the income of the estate or trust for the taxable year of the apportionment under § 1.48–6. However, once property has been treated under this subparagraph as having ceased to be section 38 property to any extent the percentage referred to shall be 33⅓ percent of the estate's, trust's, or beneficiary's proportionate interest in the income of the estate or trust for the taxable year of the apportionment under § 1.48–6.

(iii) In determining a beneficiary's proportionate interest in the income of an estate or trust for purposes of this subparagraph, the beneficiary shall be considered to own any interest in such an estate or trust which he owns directly or indirectly (through ownership in other entities provided such other entities' bases in such interest are determined in whole or in part by reference to the basis of such interest in the hands of the beneficiary). For example, if A, whose proportionate interest in the income of trust X is 30 percent, transfers all of such interest to corporation Y in exchange for all of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own a 30-percent interest in trust X. Any taxpayer who seeks to establish his interest in an estate or trust under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the estate or trust after any such transfer or transfers.

(b) *Examples.* Paragraph (a) of this section may be illustrated by the following examples in each of which it is assumed that XYZ Trust, which makes its returns on the basis of the calendar year, acquired and placed in service on June 1, 1962, three items of section 38 property. The basis and estimated useful life of each item of section 38 property are as follows:

Asset No.	Basis	Estimated useful life (Years)
1	$30,000	4
2	30,000	6
3	30,000	8

For the taxable year 1962 the income of XYZ Trust is $20,000, which is allocable equally to XYZ Trust and beneficiary A. Beneficiary A makes his returns on the basis of a calendar year. Under § 1.48–6, the total bases of the section 38 properties was

apportioned to XYZ Trust and beneficiary A as follows:

		Useful life category		
		4 to 6 years	6 to 8 years	8 years or more
Total bases		$30,000	$30,000	$30,000
	($10,000)	15,000	15,000	15,000
XYZ Trust	($20,000)			
Beneficiary A	($10,000)	15,000	15,000	15,000
	($20,000)			

Assuming that during 1962 beneficiary A did not place in service any section 38 property and that he did not own any interests in other estates, trusts, electing small business corporations, or partnerships, the qualified investment of XYZ Trust and of beneficiary A is $30,000 each, computed as follows:

Basis	Applicable percentage	Qualified investment
$15,000	33⅓	$5,000
$15,000	66⅔	10,000
$15,000	100	15,000
		30,000

For the taxable year 1962, XYZ Trust and beneficiary A each had a credit earned of $2,100 (7 percent of $30,000). Each such credit earned was allowed under section 38 as a credit against the liability for tax.

Example (1). (i) On December 2, 1965, XYZ Trust sells asset No. 3 to X Corporation.

(ii) The actual useful life of asset No. 3 is three years and six months. The recomputed qualified investment with respect to XYZ Trust's and beneficiary A's share of the basis of asset No. 3 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962, XYZ Trust's and beneficiary A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on XYZ Trust and on beneficiary A for the taxable year 1965 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

Example (2). (i) On December 3, 1964, beneficiary A sells 50 percent of his interest in the income of XYZ Trust to B, and on December 3, 1965, A sells his remaining 50 percent interest to C. In addition, on January 2, 1966, XYZ Trust sells asset No. 3 to Y Corporation.

(ii) Under paragraph (a)(2) of this section, on December 3, 1964, 50 percent of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to beneficiary A since immediately after the December 3, 1964, sale A's proportionate interest in the income of XYZ Trust is reduced to 50 percent of his proportionate interest in the income of XYZ Trust for the taxable year 1962. The actual useful life of the share of the bases of the section 38 properties which cease to be section 38 property with respect to A is two years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1964). Beneficiary A's recomputed qualified investment with respect to such properties is $15,000, computed as follows:

Basis	Applicable percentage	Qualified investment
$7,500	33⅓	$2,500
$7,500	66⅔	5,000
$7,500	100	7,500
		15,000

For the taxable year 1962 beneficiary A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on beneficiary A for the taxable year 1964 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

(iii) Under paragraph (a)(2) of this section, on December 3, 1965, the remaining 50 percent of the share of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to beneficiary A since immediately after the December 3, 1965, sale A's proportionate interest in the income of XYZ Trust is reduced to zero. The actual useful life of the share of the basis of the section 38 properties which cease to be section 38 property with respect to A is three years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1965). A's recomputed qualified investment with respect to such properties is zero. For the taxable year 1962 beneficiary A's recomputed credit earned is zero. The income tax imposed by chapter 1 of the Code on beneficiary A for the taxable year 1965 is increased by $1,050 (that is, $2,100 ($2,100 original credit earned minus zero recomputed credit earned) reduced by the $1,050 increase in tax for 1964).

(iv) The actual useful life of asset No. 3 which was sold on January 2, 1966, is three years and seven months. The recomputed

qualified investment with respect to XYZ Trust's share of the basis of asset No. 3 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962, XYZ Trust's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on XYZ Trust for the taxable year 1966 is increased by the $1,050 decrease in its credit earned for the taxable year 1962 ($2,100 original credit earned minus $1,050 recomputed credit earned). The sale of asset No. 3 on January 2, 1966, has no effect on A.

[T.D. 6931, 32 FR 14037, Oct. 10, 1967]

§ 1.47-6 Partnerships.

(a) *In general*—(1) *Disposition or cessation in hands of partnership.* If a partnership disposes of any partnership section 38 property (or if any partnership section 38 property otherwise ceases to be section 38 property in the hands of the partnership) before the close of the estimated useful life which was taken into account in computing qualified investment with respect to such property, a recapture determination shall be made with respect to each partner who is treated, under paragraph (f) of § 1.46-3, as a taxpayer with respect to such property. Each such recapture determination shall be made with respect to the share of the basis (or cost) of such property taken into account by such partner in computing his qualified investment. For purposes of each such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the partnership and ending with the date of the disposition or cessation. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determinations made with respect to the partner in connection with the same property. For definition of "recapture determination" see paragraph (a)(1) of § 1.47-1.

(2) *Disposition of partner's interest.* (i) If—

(*a*) The basis (or cost) of partnership section 38 property is taken into account by a partner in computing his qualified investment, and

(*b*) After the date on which such partnership section 38 property was placed in service by the partnership and before the close of the estimated useful life of the property, such partner's proportionate interest in the general profits of the partnership (or in the particular item of property) is reduced (for example, by a sale, by a change in the partnership agreement, or by the admission of a new partner) below the percentage specified in subdivision (ii) of this subparagraph, then, on the date of such reduction such partnership section 38 property ceases to be section 38 property with respect to such partner to the extent of the actual reduction in such partner's proportionate interest in the general profits of the partnership (or in the particular item of property). (For example, if $100 of the basis of section 38 property was taken into account by a partner and if his proportionate interest in the general profits of the partnership is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then such property shall be treated as having ceased to be section 38 property to the extent of $50.) Accordingly, a recapture determination shall be made with respect to such partner. For purposes of such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the partnership and ending with the date on which it is treated as having ceased to be section 38 property with respect to the partner. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determination made with respect to the partner in connection with the same property.

(ii) The percentage referred to in subdivision (i)(*b*) of this subparagraph is 66⅔ percent of the partner's proportionate interest in the general profits of the partnership (or in the particular item of property) for the year in which such property was placed in service. However, once property has been treated under this subparagraph as having ceased to be section 38 property to any extent the percentage referred to shall be 33⅓ percent of the partner's proportionate interest in the general profits of the partnership (or in the particular item of property) for

the year in which such property was placed in service.

(iii) In determining a partner's proportionate interest in the general profits of a partnership for purposes of this subparagraph, the partner shall be considered to own any interest in such a partnership which he owns directly or indirectly (through ownership in other entities provided the other entities' bases in such interest are determined in whole or in part by reference to the basis of such interest in the hands of the partner). For example, if A, whose proportionate interest in the general profits of partnership X is 20 percent, transfers all of such interest to corporation Y in exchange for all of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own a 20-percent interest in partnership X. Any taxpayer who seeks to establish his interest in a partnership under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the partnership after any such transfer or transfers.

(b) *Examples.* Paragraph (a) of this section may be illustrated by the following examples in each of which it is assumed that ABC Partnership, which makes its returns on the basis of the calendar year, acquired and placed in service on June 1, 1962, three items of section 38 property. The basis and estimated useful life of each item of section 38 property are as follows:

Asset No	Basis	Estimated useful life Years
1	$30,000	4
2	30,000	6
3	30,000	8

Partners A and B, who make their returns on the basis of a calendar year, share the profits and losses of ABC Partnership equally. Under paragraph (f)(2) of § 1.46-3, each partner's share of the basis of the partnership section 38 property is as follows:

Asset No.	Estimated useful life (years)	Basis	Partners share of basis	
			A 50 percent	B 50 percent
1	4	$30,000	$15,000	$15,000
2	6	30,000	15,000	15,000
3	8	30,000	15,000	15,000

Assuming that during 1962 partners A and B did not place in service any section 38 property and that they did not own any interests in other partnerships, electing small business corporations, estates, or trusts, the qualified investment of each partner is $30,000, computed as follows:

Partnership asset No.	Share of basis	Applicable percentage	Qualified investment
1	$15,000	33⅓	$5,000
2	15,000	66⅔	10,000
3	15,000	100	15,000
			30,000

For the taxable year 1962, each partner's credit earned of $2,100 (7 percent of $30,000) was allowed under section 38 as a credit against his liability for tax.

Example (1). (i) On December 2, 1965, ABC Partnership sells asset No. 3 to X Corporation.

(ii) The actual useful life of asset No. 3 is three years and six months. The recomputed qualified investment with respect to each partner's share of the basis of asset No. 3 is zero ($15,000 shares of basis multiplied by zero applicable percentage) and for the taxable year 1962, each partner's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on each of the partners for the taxable year 1965 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

Example (2). (i) On December 3, 1964, partner A sells one-half of his 50 percent interest in ABC Partnership to C, and on December 3, 1965, A sells the remaining one-half of his interest to D. In addition, on January 2, 1966, ABC Partnership sells asset No. 3 to X Corporation.

(ii) Under paragraph (a)(2) of this section, on December 3, 1964, 50 percent of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to partner A since immediately after the December 3, 1964, sale A's proportionate interest in the general profits of ABC Partnership is reduced to 50 percent of his proportionate interest in the general

profits of ABC Partnership for 1962. The actual useful life of the share of the basis of each of the section 38 properties which cease to be section 38 property with respect to A is two years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1964). Partner A's recomputed qualified investment with respect to such properties is $15,000, computed as follows:

Partnership asset No.	Share of basis	Applicable percentage	Qualified investment
1	$7,500	33⅓	$2,500
2	7,500	66⅔	5,000
3	7,500	100	7,500
			15,000

For the taxable year 1962 partner A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on partner A for the taxable year 1964 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

(iii) Under paragraph (a)(2) of this section, on December 3, 1965, the remaining 50 percent of the share of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to partner A since immediately after the December 3, 1965, sale A's proportionate interest in the general profits of ABC Partnership is reduced to zero. The actual useful life of the share of the bases of the section 38 properties which cease to be section 38 property with respect to A is three years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1965). A's recomputed qualified investment with respect to such properties is zero. For the taxable year 1962 partner A's recomputed credit earned is zero. The income tax imposed by chapter 1 of the Code on partner A for the taxable year 1965 is increased by $1,050 (that is, $2,100 ($2,100 original credit earned minus zero recomputed credit earned) reduced by the $1,050 increase in tax for 1964).

(iv) The actual useful life of asset No. 3 which was sold on January 2, 1966, is three years and seven months. The recomputed qualified investment with respect to partner B's share of the basis of asset No. 3 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962, partner B's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on partner B for the taxable year 1966 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 ($2,100 original credit earned minus $1,050 recomputed credit earned). The sale of asset No. 3 on January 2, 1966, has no effect on A.

[T.D. 6931, 32 FR 14039, Oct. 10, 1967]

§ 1.48-1 Definition of section 38 property.

(a) *In general.* Property which qualifies for the credit allowed by section 38 is known as "section 38 property". Except as otherwise provided in this section, the term "section 38 property" means property (1) with respect to which depreciation (or amortization in lieu of depreciation) is allowable to the taxpayer, (2) which has an estimated useful life of 3 years or more (determined as of the time such property is placed in service), and (3) which is either (i) tangible personal property, (ii) other tangible property (not including a building and its structural components) but only if such other property is used as an integral part of manufacturing, production, or extraction, or as an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or is a research or storage facility used in connection with any of the foregoing activities, or (iii) an elevator or escalator which satisfies the conditions of section 48(a)(1)(C). The determination of whether property qualifies as section 38 property in the hands of the taxpayer for purposes of the credit allowed by section 38 must be made with respect to the first taxable year in which such property is placed in service by the taxpayer. See paragraph (d) of § 1.46-3. For the meaning of "estimated useful life", see paragraph (e) of § 1.46-3. In the case of property which is not described in section 50, this paragraph shall be applied by substituting "4 years" for "3 years".

(b) *Depreciation allowable.* (1) Property is not section 38 property unless a deduction for depreciation (or amortization in lieu of depreciation) with respect to such property is allowable to the taxpayer for the taxable year. A deduction for depreciation is allowable if the property is of a character subject to the allowance for depreciation under section 167 and the basis (or

cost) of the property is recovered through a method of depreciation, including, for example, the unit of production method and the retirement method as well as methods of depreciation which measure the life of the property in terms of years. If property is placed in service (within the meaning of paragraph (d) of § 1.46-3) in a trade or business (or in the production of income), but under the taxpayer's depreciation practice the period for depreciation with respect to such property begins in a taxable year subsequent to the taxable year in which such property is placed in service, then a deduction for depreciation shall be treated as allowable with respect to such property in the earlier taxable year (or years). Thus, for example, if a machine is placed in service in a trade or business in 1963, but the period for depreciation with respect to such machine begins in 1964, because the taxpayer uses an averaging convention (see § 1.167(a)-10) in computing depreciation, then, for purposes of determining whether the machine qualifies as section 38 property, a deduction for depreciation shall be treated as allowable in 1963.

(2) If, for the taxable year in which property is placed in service, a deduction for depreciation is allowable to the taxpayer only with respect to a part of such property, then only the proportionate part of the property with respect to which such deduction is allowable qualifies as section 38 property for the purpose of determining the amount of credit allowable under section 38. Thus, for example, if property is used 80 percent of the time in a trade or business and is used 20 percent of the time for personal purposes, only 80 percent of the basis (or cost) of such property qualifies as section 38 property. Further, property does not qualify to the extent that a deduction for depreciation thereon is disallowed under section 274 (relating to disallowance of certain entertainment, etc., expenses).

(3) If the cost of property is not recovered through a method of depreciation but through a deduction of the full cost in one taxable year, for purposes of subparagraph (1) of this paragraph a deduction for depreciation with respect to such property is not allowable to the taxpayer. However, if an adjustment with respect to the income tax return for such taxable year requires the cost of such property to be recovered through a method of depreciation, a deduction for depreciation will be considered as allowable to the taxpayer.

(4) If depreciation sustained on property is not an allowable deduction for the taxable year but is added to the basis of property being constructed, reconstructed, or erected by the taxpayer, for purposes of subparagraph (1) of this paragraph a deduction for depreciation shall be treated as allowable for the taxable year with respect to the property on which depreciation is sustained. Thus, if $1,000 of depreciation sustained with respect to property no. 1, which is placed in service in 1964 by taxpayer A, is not allowable to A as a deduction for 1964 but is added to the basis of property being constructed by A (property no. 2), for purposes of subparagraph (1) of this paragraph a deduction for depreciation shall be treated as allowable to A for 1964 with respect to property no. 1. However, the $1,000 amount is not included in the basis of property no. 2 for purposes of determining A's qualified investment with respect to property no. 2. See paragraph (c)(1) of § 1.46-3.

(c) *Definition of tangible personal property.* If property is tangible personal property it may qualify as section 38 property irrespective of whether it is used as an integral part of an activity (or constitutes a research or storage facility used in connection with such activity) specified in paragraph (a) of this section. Local law shall not be controlling for purposes of determining whether property is or is not "tangible" or "personal". Thus, the fact that under local law property is held to be personal property or tangible property shall not be controlling. Conversely, property may be personal property for purposes of the investment credit even though under local law the property is considered to be a fixture and therefore real property. For purposes of this section, the term "tangible personal property" means any tangible property except land and

improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by section 38. Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property.

(d) *Other tangible property*—(1) *In general.* In addition to tangible personal property, any other tangible property (but not including a building and its structural components) used as an integral part of manufacturing, production, or extraction, or as an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or which constitutes a research or storage facility used in connection with any of the foregoing activities, may qualify as section 38 property.

(2) *Manufacturing, production, and extraction.* For purposes of the credit allowed by section 38, the terms "manufacturing", "production", and "extraction" include the construction, reconstruction, or making of property out of scrap, salvage, or junk material, as well as from new or raw material, by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles, and include the cultivation of the soil, the raising of livestock, and the mining of minerals. Thus, section 38 property would include, for example, property used as an integral part of the extracting, processing, or refining of metallic and nonmetallic minerals, including oil, gas, rock, marble, or slate; the construction of roads, bridges, or housing; the processing of meat, fish or other foodstuffs; the cultivation of orchards, gardens, or nurseries; the operation of sawmills, the production of lumber, lumber products or other building materials; the fabrication or treatment of textiles, paper, leather goods, or glass; and the rebuilding, as distinguished from the mere repairing, of machinery.

(3) *Transportation and communications businesses.* Examples of transportation businesses include railroads, airlines, bus companies, shipping or trucking companies, and oil pipeline companies. Examples of communications businesses include telephone or telegraph companies and radio or television broadcasting companies.

(4) *Integral part.* In order to qualify for the credit, property (other than tangible personal property and research or storage facilities used in connection with any of the activities specified in subparagraph (1) of this paragraph) must be used as an integral part of one or more of the activities specified in subparagraph (1) of this paragraph. Property such as pavements, parking areas, inherently permanent advertising displays or inherently permanent outdoor lighting facilities, or swimming pools, although used in the operation of a business, ordinarily is not used as an integral part of any of such specified activities. Property is used as an integral part of one of the specified activities if it is used directly in the activity and is essential to the completeness of the activity. Thus, for example, in determining whether property is used as an integral part of manufacturing, all properties used by the taxpayer in acquiring or transporting raw materials or supplies to the point where the actual processing commences (such as docks, railroad tracks and bridges), or in processing raw materials into the tax-

payer's final product, would be considered as property used as an integral part of manufacturing. Specific examples of property which normally would be used as an integral part of one of the specified activities are blast furnaces, oil and gas pipelines, railroad tracks and signals, telephone poles, broadcasting towers, oil derricks, and fences used to confine livestock. Property shall be considered used as an integral part of one of the specified activities if so used either by the owner of the property or by the lessee of the property.

(5) *Research or storage facilities.* (i) If property (other than a building and its structural components) constitutes a research or storage facility and if it is used in connection with an activity specified in subparagraph (1) of this paragraph, such property may qualify as section 38 property even though it is not used as an integral part of such activity. Examples of research facilities include wind tunnels and test stands. Examples of storage facilities include oil and gas storage tanks and grain storage bins. Although a research or storage facility must be used in connection with, for example, a manufacturing process, the taxpayer-owner of such facility need not be engaged in the manufacturing process.

(ii) In the case of property described in section 50, property will constitute a storage facility only if the facility is used principally for the bulk storage of fungible commodities. Bulk storage means the storage of a commodity in a large mass prior to its consumption or utilization. Thus, if a facility is used to store oranges that have been sorted and boxed, it is not used for bulk storage.

(e) *Definition of building and structural components.* (1) Buildings and structural components thereof do not qualify as section 38 property. The term "building" generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. Such term includes any such structure constructed by, or for, a lessee even if such structure must be removed, or ownership of such structure reverts to the lessor, at the termination of the lease. Such term does not include (i) a structure which is essentially an item of machinery or equipment, or (ii) a structure which houses property used as an integral part of an activity specified in section 48(a)(1)(B)(i) if the use of the structure is so closely related to the use of such property that the structure clearly can be expected to be replaced when the property it initially houses is replaced. Factors which indicate that a structure is closely related to the use of the property it houses include the fact that the structure is specifically designed to provide for the stress and other demands of such property and the fact that the structure could not be economically used for other purposes. Thus, the term "building" does not include such structures as oil and gas storage tanks, grain storage bins, silos, fractionating towers, blast furnaces, basic oxygen furnaces, coke ovens, brick kilns, and coal tipples.

(2) The term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building. However, the term "structural components" does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the "sole justification" test provided by

the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential. For example, an air conditioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term "structural components". For special rules with respect to an elevator or escalator, the construction, reconstruction, or erection of which is completed by the taxpayer after June 30, 1963, or which is acquired after June 30, 1963, and the original use of which commences with the taxpayer and commences after such date, see section 48(a)(1)(C) and paragraph (m) of this section.

(f) *Intangible property.* Intangible property, such as patents, copyrights, and subscription lists, does not qualify as section 38 property. The cost of intangible property, in the case of a patent or copyright, includes all costs of purchasing or producing the item patented or copyrighted. Thus, in the case of a motion picture or television film or tape, the cost of the intangible property includes manuscript and screenplay costs, the cost of wardrobe and set design, the salaries of cameramen, actors, directors, etc., and all other costs properly includible in the basis of such film or tape. In the case of a book, the cost of the intangible property includes all costs of producing the original copyrighted manuscript, including the cost of illustration, research, and clerical and stenographic help. However, if tangible depreciable property is used in the production of such intangible property, see paragraph (b)(4) of this section.

(g) *Property used outside the United States*—(1) *General rule.* (i) Except as provided in subparagraph (2) of this paragraph, the term "section 38 property" does not include property which is used predominantly outside the United States (as defined in section 7701(a)(9)) during the taxable year. The determination of whether property is used predominantly outside the United States during the taxable year shall be made by comparing the period of time in such year during which the property is physically located outside the United States with the period of time in such year during which the property is physically located within the United States. If the property is physically located outside the United States during more than 50 percent of the taxable year, such property shall be considered used predominantly outside the United States during that year. If property is placed in service after the first day of the taxable year, the determination of whether such property is physically located outside the United States during more than 50 percent of the taxable year shall be made with respect to the period beginning on the date on which the property is placed in service and ending on the last day of such taxable year.

(ii) Since the determination of whether a credit is allowable to the taxpayer with respect to any property may be made only with respect to the taxable year in which the property is placed in service by the taxpayer, property used predominantly outside the United States during the taxable year in which it is placed in service cannot qualify as section 38 property with respect to such taxpayer, regardless of the fact that the property is permanently returned to the United States in a later year. Furthermore, if property is used predominantly in the United States in the year in which it is placed in service by the taxpayer, and a credit under section 38 is allowed with respect to such property, but such property is thereafter in any one year used predominantly outside the United States, such property ceases to be section 38 property with respect to the taxpayer and is subject to the application of section 47.

(iii) This subparagraph applies whether property is used predominantly outside the United States by the owner of the property, or by the lessee of the property. If property is leased and if the lessor makes a valid election under § 1.48-4 to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, the determination of whether such property is physically located outside the United States

during more than 50 percent of the taxable year shall be made with respect to the taxable year of the lessee; however, if the lessor does not make such an election, such determination shall be made with respect to the taxable year of the lessor.

(2) *Exceptions.* The provisions of subparagraph (1) of this paragraph do not apply to—

(i) Any aircraft which is registered by the Administrator of the Federal Aviation Agency, and which (*a*) is operated, whether on a scheduled or nonscheduled basis, to and from the United States, or (*b*) is placed in service by the taxpayer during a taxable year ending after March 9, 1967, and is operated under contract with the United States: *Provided*, That use of the aircraft under the contract constitutes its principal use outside the United States during the taxable year. The term "to and from the United States" is not intended to exclude an aircraft which makes flights from one point in a foreign country to another such point, as long as such aircraft returns to the United States with some degree of frequency;

(ii) Rolling stock, of a domestic railroad corporation subject to part I of the Interstate Commerce Act, which is used within and without the United States. For purposes of this subparagraph, the term "rolling stock" means locomotives, freight and passenger train cars, floating equipment, and miscellaneous transportation equipment on wheels, the expenditures for which are chargeable (or, in the case of leased property, would be chargeable) to the equipment investment accounts in the uniform system of accounts for railroad companies prescribed by the Interstate Commerce Commission;

(iii) Any vessel documented under the laws of the United States which is operated in the foreign or domestic commerce of the United States. A vessel is documented under the laws of the United States if it is registered, enrolled, or licensed under the laws of the United States by the Commandant, U.S. Coast Guard. Vessels operated in the foreign or domestic commerce of the United States include those documented for use in foreign trade, coastwise trade, or fisheries;

(iv) Any motor vehicle of a United States person (as defined in section 7701(a)(30)) which is operated to and from the United States with some degree of frequency;

(v) Any container of a United States person which is used in the transportation of property to and from the United States;

(vi) Any property (other than a vessel or an aircraft) of a U.S. person which is used for the purpose of exploring for, developing, removing, or transporting resources from the outer Continental Shelf (within the meaning of section 2 of the Outer Continental Shelf Lands Act, as amended and supplemented; 43 U.S.C., sec. 1331). Thus for example, offshore drilling equipment may be section 38 property;

(vii) Any property placed in service after December 31, 1965 which (*a*) is owned by a domestic corporation (other than a corporation entitled to the benefits of section 931 or 934(b)) or by a United States citizen (other than a citizen entitled to the benefits of section 931, 932, 933, or 934(c)), and (*b*) is used predominantly in a possession of the United States during the taxable year by such a corporation or such a citizen, or by a corporation created or organized in, or under the law of, a possession of the United States. Thus, property placed in service after December 31, 1965, which is owned by a domestic corporation not entitled to the benefits of section 931 or 934(b), which is leased to a corporation organized under the laws of a U.S. possession, and which is used by such lessee predominantly in a possession of the United States may qualify as section 38 property. However, property which is owned by a corporation not entitled to the benefits of section 931 or 934(b) but which is leased to a domestic corporation entitled to such benefits would not qualify as section 38 property. The determination of whether property is used predominantly in a possession of the United States during the taxable year shall be made under principles similar to those described in subparagraph (1) of this paragraph. For example, if a machine is placed in service in a possession of the United

States on July 1, 1966, by a calendar year taxpayer and if it is physically located in such a possession during more than 50 percent of the period beginning on July 1, 1966 and ending on December 31, 1966, then such machine shall be considered used predominantly in a possession of the United States during the taxable year 1966;

(viii) Any communications satellite (as defined in section 103(3) of the Communications Satellite Act of 1962, 47 U.S.C., sec. 702(3)), or any interest therein, of a U.S. person;

(ix) Any cable which is property described in section 50, or any interest therein, of a domestic corporation engaged in furnishing telephone service to which section 46(c)(3)(B)(iii) applies (or of a wholly owned domestic subsidiary of such corporation), if such cable is part of a submarine cable system which constitutes part of a communications link exclusively between the United States and one or more foreign countries; and

(x) Any property described in section 50 (other than a vessel or an aircraft) of a U.S. person which is used in international or territorial waters for the purpose of exploring for, developing, removing, or transporting resources from ocean waters or deposits under such waters.

(h) *Property used for lodging*—(1) *In general.* (i) Except as provided in subparagraph (2) of this paragraph, the term "section 38 property" does not include property which is used predominantly to furnish lodging or is used predominantly in connection with the furnishing of lodging during the taxable year. Property used in the living quarters of a lodging facility, including beds and other furniture, refrigerators, ranges, and other equipment, shall be considered as used predominantly to furnish lodging. The term "lodging facility" includes an apartment house, hotel, motel, dormitory, or any other facility (or part of a facility) where sleeping accommodations are provided and let, except that such term does not include a facility used primarily as a means of transportation (such as an aircraft, vessel, or a railroad car) or used primarily to provide medical or convalescent services, even though sleeping accommodations are provided.

(ii) Property which is used predominantly in the operation of a lodging facility or in serving tenants shall be considered used in connection with the furnishing of lodging, whether furnished by the owner of the lodging facility or another person. Thus, for example, lobby furniture, office equipment, and laundry and swimming pool facilities used in the operation of an apartment house or in serving tenants would be considered used predominantly in connection with the furnishing of lodging. However, property which is used in furnishing, to the management of a lodging facility or its tenants, electrical energy, water, sewage disposal services, gas, telephone service, or other similar services shall not be treated as property used in connection with the furnishing of lodging. Thus, such items as gas and electric meters, telephone poles and lines, telephone station and switchboard equipment, and water and gas mains, furnished by a public utility would not be considered as property used in connection with the furnishing of lodging.

(2) *Exceptions*—(i) *Nonlodging commercial facility.* A nonlodging commercial facility which is available to persons not using the lodging facility on the same basis as it is available to the tenants of the lodging facility shall not be treated as property which is used predominantly to furnish lodging or predominantly in connection with the furnishing of lodging. Examples of non-lodging commercial facilities include restaurants, drug stores, grocery stores, and vending machines located in a lodging facility.

(ii) *Property used by a hotel or motel.* Property used by a hotel, motel, inn, or other similar establishment, in connection with the trade or business of furnishing lodging shall not be considered as property which is used predominantly to furnish lodging or predominantly in connection with the furnishing of lodging, provided that the predominant portion of the living accommodations in the hotel, motel, etc., is used by transients during the taxable year. For purposes of the preceding sentence, the term "predomi-

nant portion" means "more than one-half". Thus, if more than one-half of the living quarters of a hotel, motel, inn, or other similar establishment is used during the taxable year to accommodate tenants on a transient basis, none of the property used by such hotel, motel, etc., in the trade or business of furnishing lodging shall be considered as property which is used predominantly to furnish lodging or predominantly in connection with the furnishing of lodging. Accommodations shall be considered used on a transient basis if the rental period is normally less than 30 days.

(iii) *Coin-operated machines.* In the case of property which is described in section 50, coin-operated vending machines and coin-operated washing machines and dryers shall not be considered as property which is used predominantly to furnish lodging or predominantly in connection with the furnishing of lodging.

(i) [Reserved]

(j) *Property used by certain tax-exempt organizations.* The term "section 38 property" does not include property used by an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1 of the Code unless such property is used predominantly in an unrelated trade or business the income of which is subject to tax under section 511. If such property is debt-financed property as defined in section 514(b), the basis or cost of such property for purposes of computing qualified investment under section 46(c) shall include only that percentage of the basis or cost which is the same percentage as is used under section 514(a), for the year the property is placed in service, in computing the amount of gross income to be taken into account during such taxable year with respect to such property. The term "property used by an organization" means (1) property owned by the organization (whether or not leased to another person), and (2) property leased to the organization. Thus, for example, a data processing or copying machine which is leased to an organization exempt from tax would be considered as property used by such organization. Property (unless used predominantly in an unrelated trade or business) leased by another person to an organization exempt from tax or leased by such an organization to another person is not section 38 property to either the lessor or the lessee, and in either case the lessor may not elect under § 1.48-4 to treat the lessee of such property as having purchased such property for purposes of the credit allowed by section 38. This paragraph shall not apply to property leased on a casual or short-term basis to an organization exempt from tax.

(k) *Property used by governmental units.* The term "section 38 property" does not include property used by the United States, any State (including the District of Columbia) or political subdivision thereof, any international organization (as defined in section 7701(a)(18)) other than the International Telecommunications Satellite Consortium or any successor organization, or any agency or instrumentality of the United States, of any State or political subdivision thereof, or of any such international organization. The term "property used by the United States, etc." means (1) property owned by any such governmental unit (whether or not leased to another person), and (2) property leased to any such governmental unit. Thus, for example, a data processing or copying machine which is leased to any such governmental unit would be considered as property used by such governmental unit. Property leased by another person to any such governmental unit or leased by such governmental unit to another person is not section 38 property to either the lessor or the lessee, and in either case the lessor may not elect under § 1.48-4 to treat the lessee of such property as having purchased such property for purposes of the credit allowed by section 38. This paragraph shall not apply to property leased on a casual or short-term basis to any such governmental unit.

(l) *Livestock*—(1) *In general.* The term "section 38 property" does not include horses but such term does include all other livestock that is property described in section 50. The term "livestock" includes cattle, hogs,

sheep, goats, and mink and other fur-bearing animals.

(2) *Cost.* For purposes of computing qualified investment under section 46(c) with respect to livestock, the cost of livestock acquired by the taxpayer shall be reduced by any amount realized on the sale or other disposition of substantially identical livestock which is sold or otherwise disposed of by the taxpayer during the 1-year period beginning 6 months before the date of such acquisition, except that no reduction shall be made on account of a sale or other disposition to which section 47(a) (relating to recapture) applies or which constitutes an involuntary conversion (within the meaning of section 1033). If a particular sale or other disposition of substantially identical livestock falls within 2 or more 1-year periods relating to separate acquisitions, the amount realized from such sale or other disposition shall be applied in order of time beginning with the earliest acquisition of livestock which is section 38 property. If there is more than one sale or other disposition of substantially identical livestock during a particular 1-year period, the sales or dispositions are to be taken into account in order of time beginning with the earliest. If an amount realized from a sale or other disposition has been taken into account to reduce the cost of acquired livestock, such amount is not to be taken into account to reduce the cost of any other acquired livestock. If a taxpayer claims a credit for any livestock acquired in a taxable year and if the amount realized on any sale or other disposition of substantially identical livestock in a subsequent taxable year is applied to reduce the cost of the acquired livestock, the taxpayer must file an amended return for the year in which the credit was claimed.

(3) *Substantially identical.* In determining whether livestock sold or otherwise disposed of by the taxpayer is substantially identical to livestock acquired by the taxpayer, the sex and age of the livestock and the use to which it is put are taken into account. Thus, if the taxpayer sells a cow used for breeding purposes and acquires another cow of approximately the same age to be used for breeding purposes, the two cows are substantially identical. However, a cow suitable for dairy purposes which is acquired by the taxpayer to replace a cow no longer suitable for dairy purposes is not substantially identical to the replaced cow.

(4) *Original use.* For purposes of determining whether livestock is "new section 38 property," that is, whether the original use of livestock commences with the taxpayer under § 1.48-2(b)(7), the original use of a breeding or dairy animal for breeding or dairy purposes begins at the time the animal first becomes suitable for such purposes unless the animal has previously been used for other purposes. Thus, if a taxpayer acquires for dairy purposes an animal that previously has not been used for any purpose, the animal will be new section 38 property at the time it first gives milk. However, if the taxpayer acquires an animal for breeding purposes which previously had been used for dairy purposes, the animal will not be new section 38 property when it is first used for breeding purposes.

(5) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). (a) Individual A, a farmer and calendar year taxpayer, owns three dairy cows which he purchased in 1970 for $250 each. In 1971, A buys three dairy cows, one each on October 1, November 1, and December 1, for $290 each. On October 15, 1971, A sells for $300 one of the cows purchased in 1970, and on November 15, 1971, he sells for $300 another of the cows purchased in 1970. All of the cows bought and sold by A are substantially identical. The cows purchased by A have an estimated useful life of 5 years.

(b) Of the $300 realized from the October 15 sale, $290 is applied to reduce the cost of the cow purchased October 1 to zero. The remaining $10 realized from the October 15 sale and $280 of the $300 realized from the November 15 sale are applied to reduce the cost of the cow purchased November 1 to zero. The remaining $20 realized from the November 15 sale is applied to reduce the cost of the cow purchased December 1 to $270.

(c) Since the basis of the cows purchased October 1 and November 1 is zero for investment credit purposes, no credit is allowable with respect to those two cows. The cow purchased December 1 has a basis for investment credit purposes of $270. Since the

useful life of the cow purchased December 1 is at least 5 years but less than 7 years, the qualified investment of A with respect to the cow is $180 (⅔ × $270).

Example (2). Assume the same facts as in example (1) except that on May 1, 1972, A sells for $300 the third cow purchased in 1970. Since the third cow is sold within 6 months of the acquisition of the cow purchased December 1, 1971, the amount realized on such sale is applied to reduce the cost of the cow purchased December 1, 1971, to zero. Consequently, A must file an amended return for 1971 and claim no investment credit for the cow purchased December 1, 1971.

(m) *Elevators and escalators*—(1) *In general.* Under section 48(a)(1)(C), an elevator or escalator qualifies as section 38 property if—

(i) The construction, reconstruction, or erection of the elevator or escalator is completed by the taxpayer after June 30, 1963, or

(ii) The elevator or escalator is acquired after June 30, 1963, and the original use of such elevator or escalator commences with the taxpayer and commences after such date.

In the case of construction, reconstruction, or erection of an elevator or escalator commenced before January 1, 1962, and completed after June 30, 1963, there shall be taken into account in determining the qualified investment under section 46(c) only that portion of the basis which is properly attributable to construction, reconstruction, or erection after December 31, 1961. Further, if the construction, reconstruction, or erection of such property is commenced after December 31, 1961, and is completed after June 30, 1963, the entire basis of the elevator or escalator shall be taken into account in determining qualified investment under section 46(c). Also, if an elevator or escalator is reconstructed by the taxpayer after June 30, 1963, the basis attributable to such reconstruction may be taken into account in determining the qualified investment under section 46(c), irrespective of the fact that the original construction or erection of such elevator or escalator may have occurred before January 1, 1962. Paragraph (b) of § 1.48-2 shall be applied in determining the date of acquisition, original use, and basis attributable to construction, reconstruction, or erection.

(2) *Definition of elevators and escalators.* For purposes of this section the term "elevator" means a cage or platform and its hoisting machinery for conveying persons or freight to or from different levels and functionally related equipment which is essential to its operation. The term includes, for example, guide rails and cables, motors and controllers, control panels and landing buttons, and elevator gates and doors, which are essential to the operation of the elevator. The term "elevator" does not, however, include a structure which is considered a building for purposes of the investment credit. The term "escalator" means a moving staircase and functionally related equipment which is essential to its operation. For purposes of determining qualified investment under section 46(c) and § 1.46-3, the basis of an elevator or escalator does not include the cost of any structural alterations to the building, such as the cost of constructing a shaft or of making alterations to the floor, walls, or ceiling, even though such alterations may be necessary in order to install or modernize the elevator or escalator.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). If an elevator with a total basis of $100,000 is completed after June 30, 1963, and the portion attributable to construction by the taxpayer after December 31, 1961, is determined by engineering estimates or by cost accounting records to be $30,000, only the $30,000 portion may be taken into account as an investment in new section 38 property in computing qualified investment.

Example (2). If construction of an elevator with a total basis of $90,000 is commenced by the taxpayer after December 31, 1961, and is completed after June 30, 1963, the entire basis of $90,000 may be taken into account as an investment in new section 38 property.

Example (3). The facts are the same as in example (2) except that construction of the elevator was completed before June 30, 1963. The elevator is not considered to be section 38 property.

Example (4). In 1964, a taxpayer reconditions an elevator, which had been constructed and placed in service in 1962 and which

had an adjusted basis in 1964 of $75,000. The cost of reconditioning amounts to an additional $50,000. The basis of the elevator which may be taken into account in computing qualified investment in section 38 property is $50,000, irrespective of whether the taxpayer contracts to have it reconditioned or reconditions it himself, and irrespective of whether the materials used in the process are new in use.

(n) *Amortized property.* Any property with respect to which an election under 167(k), 169, 184, 187, or 188 applies shall not be treated as section 38 property. In the case of any property to which section 169 applies, the preceding sentence shall apply only to so much of the adjusted basis of the property as (after the application of section 169(f)) constitutes the amortizable basis for purposes of section 169. This paragraph shall not apply to property with respect to which an election under section 167(k), 184, 187, or 188 applies unless such property is described in section 50.

(o) *Property of foreign origin*—(1) *In general.* Property (other than pretermination property) shall not be treated as section 38 property if (i) such property was completed outside the United States, or (ii) less than 50 percent of the basis or cost of such property is attributable to value added within the United States. For purposes of this paragraph, the term "United States" includes the Commonwealth of Puerto Rico and the possessions of the United States.

(2) *Period of application.* (i) Subparagraph (1) of this paragraph shall apply only to property described in section 50—

(*a*) The construction, reconstruction, or erection of which by the taxpayer is begun after August 15, 1971, and before December 20, 1971, or

(*b*) Which is acquired pursuant to an order placed before December 20, 1971, unless acquired pursuant to an order which the taxpayer establishes was placed before August 16, 1971.

The principles of § 1.48-2 (b) and (c) shall be applied in determining when construction, reconstruction, or erection by the taxpayer begins. An order is any directive, written or oral, to another person reasonably designed to effect the acquisition of property at a later date. An order need not be a binding contract. Where an order placed during the surcharge period (August 16, 1971, through December 19, 1971) is canceled and a reorder is placed which is substantially the reinstitution of the original order, the property acquired as a result of the reorder is considered to be acquired pursuant to the original order.

(ii) See section 48(a)(7) (C) and (D) for circumstances under which the President of the United States may provide by Executive order for the period specified in such order that (*a*) section 48(a)(7)(A) shall not apply to certain property, or (*b*) such section shall apply to certain property notwithstanding the termination of Proclamation 4074.

(3) *Property completed outside the United States.* Property is completed outside the United States if it enters the country in a form which is operational for the purposes for which it is intended or designed, regardless of the United States content of the property. Property is in an operational state even though it is necessary to perform minor activities such as packaging, labeling, testing, or adjusting. On the other hand, substantial assembly of an article in the United States, such as in the case of aircraft, the installation of the customer's engines, or the installation of navigation equipment and the completion of the seating and interior arrangements, is to be considered completion of the article in the United States, rather than outside the United States.

(4) *Value added within the United States.* In determining whether less than 50 percent of the basis of property is attributable to value added within the United States, shipping and insurance costs incurred in transporting any part of such property to the United States and any duty payable upon entry of the property into the United States are treated as value added without the United States. Profit realized on the sale of property completed in the United States, and any profit attributable to any other U.S. activity, is treated as value added within the United States. The cost of any component part of the property (whether added to the property within

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or without the United States) which originates and is completed in the United States and meets the United States value added test is treated as value added within the United States.

(Sec. 38(b), 76 Stat. 963; 26 U.S.C. 38)

[T.D. 6731, 29 FR 6073, May 8, 1964, as amended by T.D. 6838, 30 FR 9060, July 20, 1965; T.D. 6958, 33 FR 9171, June 21, 1968; T.D. 6971, 33 FR 12899, Sept. 12, 1968; T.D. 7203, 37 FR 17129, Aug. 25, 1972; T.D. 7229, 37 FR 28142, Dec. 21, 1972]

§ 1.48-2 New section 38 property.

(a) *In general.* Section 48(b) defines "new section 38 property" as section 38 property—

(1) The construction, reconstruction, or erection of which is completed by the taxpayer after December 31, 1961, or

(2) Which is acquired by the taxpayer after December 31, 1961, provided that the original use of such property commences with the taxpayer and commences after such date.

In the case of construction, reconstruction, or erection of such property commenced before January 1, 1962, and completed after December 31, 1961, there shall be taken into account as the basis of new section 38 property in determining qualified investment only that portion of the basis which is properly attributable to contruction, reconstruction, or erection after December 31, 1961. See § 1.48-1 for the definition of section 38 property.

(b) *Special rules for determining date of acquisition, original use, and basis attributable to construction, reconstruction, or erection.* For purposes of paragraph (a) of this section, the principles set forth in paragraph (a) (1) and (2) of § 1.167(c)-1 shall be applied. Thus, for example, the following rules are applicable:

(1) Property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications.

(2) The portion of the basis of property attributable to construction, reconstruction, or erection after December 31, 1961, consists of all costs of construction, reconstruction, or erection allocable to the period after December 31, 1961, including the cost or other basis of materials entering into such work (but not including, in the case of reconstruction of property, the adjusted basis of the reconstructed property as of the time such reconstruction is commenced).

(3) It is not necessary that materials entering into construction, reconstruction, or erection be acquired after December 31, 1961, or that they be new in use.

(4) If construction or erection by the taxpayer began after December 31, 1961, the entire cost or other basis of such construction or erection may be taken into account as the basis of new section 38 property.

(5) Construction, reconstruction, or erection by the taxpayer begins when physical work is started on such construction, reconstruction, or erection.

(6) Property shall be deemed to be acquired when reduced to physical possession, or control.

(7) The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. For example, a reconditioned or rebuilt machine acquired by the taxpayer will not be treated as being put to original use by the taxpayer. The question of whether property is reconditioned or rebuilt property is a question of fact. Property will not be treated as reconditioned or rebuilt merely because it contains some used parts.

If the cost of reconstruction may properly either be capitalized and recovered through depreciation or charged against the depreciation reserve, such cost may be taken into account as the basis of new section 38 property even though it is charged against the depreciation reserve.

(c) *Examples.* This section may be illustrated by the following examples:

Example (1). If a machine with a total cost of $100,000 is completed after December 31, 1961, and the portion attributable to construction by the taxpayer after December 31, 1961, is determined by engineering estimates or by cost accounting records to be $30,000, the $30,000 amount shall be taken into account by the taxpayer in computing qualified investment in new section 38 property.

Example (2). In 1965, a taxpayer reconditions a machine, which he constructed and placed in service in 1962 and which has an adjusted basis in 1965 of $10,000. The cost of reconditioning amounts to an additional $20,000. The basis of the machine which shall be taken into account in computing qualified investment in new section 38 property for 1965 is $20,000, whether he contracts to have it reconditioned or reconditions it himself, and irrespective of whether the materials used for reconditioning are new in use.

Example (3). In 1961, a taxpayer pays the entire purchase price of $10,000 for section 38 property to be delivered in 1962. In 1962 he takes possession of the property and commences the original use of the asset in that year. The $10,000 amount shall be taken into account in computing qualified investment in new section 38 property for 1962.

Example (4). A taxpayer, instead of reconditioning his old machine, buys a "factory reconditioned" or "rebuilt" machine in 1962 to replace it. The reconditioned or rebuilt machine is not new section 38 property since such taxpayer is not the first user of the machine. See, however, § 1.48-3 (relating to used section 38 property).

Example (5). In 1962, a taxpayer buys from X for $20,000 an item of section 38 property which has been previously used by X. The taxpayer in 1962 makes an expenditure on the property of $5,000 of the type that must be capitalized. Regardless of whether the $5,000 is added to the basis of such property or is capitalized in a separate account, such amount shall be taken into account by the taxpayer in computing qualified investment in new section 38 property for 1962. No part of the $20,000 purchase price may be taken into account for such purpose. See, however, § 1.48-3 (relating to used section 38 property).

[T.D. 6731, 29 FR 6076, May 8, 1964]

§ 1.48-3 Used section 38 property.

(a) *In general.* (1) Section 48(c) provides that "used section 38 property" means section 38 property acquired by purchase after December 31, 1961, which is not "new section 38 property." See §§ 1.48-1 and 1.48-2, respectively, for definitions of section 38 property and new section 38 property. In determining whether property is acquired by purchase, the provisions of paragraph (c)(1) of § 1.179-3 shall apply, except that (i) "1961" shall be substituted for "1957", and (ii) the definition of "component member" of a controlled group of corporations in paragraph (d)(4) of this section shall be substituted for the definition of such term in paragraph (e) of § 1.179-3.

(2) (i) Property shall not qualify as used section 38 property if, after its acquisition by the taxpayer, it is used by (*a*) a person who used such property before such acquisition, or (*b*) a person who bears a relationship described in section 179(d)(2) (A) or (B) to a person who used such property before such acquisition. Thus, for example, if property is used by a person and is later sold by him under a sale and lease-back arrangement, such property in the hands of the purchaser-lessor is not used section 38 property because the property, after its acquisition, is being used by the same person who used it before its acquisition. Similarly, where a lessee has been leasing property and subsequently purchases it (whether or not the lease contains an option to purchase), such property is not used section 38 property with respect to the purchaser because the property is being used by the same person who used it before its acquisition. In addition, if property owned by a lessor is sold subject to the lease, or is sold upon the termination of the lease, the property will not qualify as used section 38 property with respect to the purchaser if, after the purchase, the property is used by a person who used the property as a lessee before the purchase.

(ii) For purposes of applying subdivision (i) of this subparagraph, (*a*) property used by a partnership shall be considered as used by each partner, and (*b*) property shall not be considered as used by a person before its acquisition if such property was used only on a casual basis by such person.

(iii) In determining whether a person bears a relationship described in section 179(d)(2) (A) or (B) to a person who used property before its acquisition by the taxpayer, the provisions of paragraph (c)(1) (i) and (ii) of § 1.179-3 shall apply, except that the definition of "component member" of a controlled group of corporations in paragraph (d)(4) of this section shall be substituted for the definition of such term in paragraph (e) of § 1.179-3.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example (1). Corporation P acquires properties 1 and 2 in 1960 and uses them in its trade or business until 1962. In 1962, corporation P sells such properties to corporation Y, which leases back property 1 to corporation P and leases property 2 to corporation S, a wholly owned subsidiary of corporation P. Property 1 is not used section 38 property in the hands of corporation Y because, after its acquisition by corporation Y, it is used by a person (corporation P) who used it prior to such acquisition. Property 2 is not used section 38 property because, after its acquisition by corporation Y, it is used by a person (corporation S) who is related, within the meaning of section 179(d)(2)(B), to a person (corporation P) who used it before such acquisition.

Example (2). In 1962, corporation L leases property from corporation M. In 1964, corporation L acquires the property that it previously had been leasing. The property acquired by corporation L is not used section 38 property because such property is used after such acquisition by the same person (corporation L) who used the property before its acquisition (corporation L).

Example (3). Corporation X buys property in 1962 and leases such property to corporation Y. Corporation X in 1965 sells the property to A subject to the lease. The property acquired by A is not used section 38 property if such property continues to be used by corporation Y, because corporation Y used the property before its acquisition by A.

Example (4). A owns a bulldozer which he rents out to a number of different users, including B. In 1962, B used the bulldozer from February 16 to March 12 and again on October 15 and 16. B purchases the bulldozer from A on December 1, 1962. The prior use of the property by B does not disqualify such property as used section 38 property to B, because he used such property only on a casual basis prior to its purchase.

Example (5). C places machine 1 in service in his individually owned business during 1961. During 1963, C sells machine 1 to partnership CDE in which he shares one-third of the profits and losses. The machine is not used section 38 property to partnership CDE because it is used after acquisition by the same person (partner C) who used the property before acquisition. Similarly, if partnership CDE places machine 2 in service during 1961 and sells that machine to partner C during 1963, machine 2 would not be used section 38 property to partner C. Moreover, if F buys partner C's interest in partnership CDE, such acquisition would not result in the acquisition of used section 38 property by F (whether or not the optional adjustment to basis of partnership property provided by section 743 applies) because the partnership property is used, after F acquires his interest, by the same persons (partners D and E) who used the property before the acquisition.

(b) *Cost.* (1) The cost of used section 38 property is equal to the basis of such property, but does not include so much of such basis as is determined by reference to the adjusted basis of other property (whether or not section 38 property) held at any time by the taxpayer acquiring such used section 38 property.

(2) If property (whether or not section 38 property) is disposed of by the taxpayer (other than by reason of its destruction or damage by fire, storm, shipwreck, or other casualty, or its theft) and used section 38 property similar or related in service or use is acquired as a replacement therefor in a transaction in which the basis of the replacement property is not determined by reference to the adjusted basis of the property replaced, then the cost of the used section 38 property so acquired shall be its basis reduced by the adjusted basis of the property replaced. The preceding sentence shall apply only if the taxpayer acquires (or enters into a contract to acquire) the replacement property within a period of 60 days before or after the date of the disposition.

(3) Notwithstanding subparagraphs (1) and (2) of this paragraph, the cost of used section 38 property shall not be reduced with respect to the adjusted basis of any property disposed of if, by reason of section 47, such disposition resulted in an increase of tax or a reduction of investment credit carrybacks or carryovers described in section 46(b).

(4) The provisions of this paragraph may be illustrated by the following examples:

Example (1). In 1972, A acquires machine 2 (an item of used section 38 property which has a sales price of $5,600) by trading in machine 1 (an item of section 38 property acquired in 1962), and by paying an additional $4,000 cash. The adjusted basis of machine 1 is $1,600. Under the provisions of sections 1012 and 1031(d), the basis of machine 2 is $5,600 ($1,600 adjusted basis of machine 1 plus cash expended of $4,000). The cost of machine 2 which may be taken into account

in computing qualified investment for 1972 is $4,000 (basis of $5,600 less $1,600 adjusted basis of machine 1).

Example (2). The facts are the same as in example (1) except that machine 2 has a sales price of $6,000. The trade-in allowance on machine 1 is $2,000. The result is the same as in example (1), that is, the basis of machine 2 is $5,600 ($1,600 plus $4,000); therefore, the cost of machine 2 which may be taken into account in computing qualified investment for 1972 is $4,000 (basis of $5,600 less $1,600 adjusted basis of machine 1).

Example (3). On September 18, 1962, B sells truck 1, which he acquired in 1961 and which has an adjusted basis in his hands of $1,200. On October 15, 1962, he purchases for $2,000 truck 2 (an item of used section 38 property) as a replacement therefor. The cost of truck 2 which may be taken into account in computing qualified investment is $800 ($2,000 less $1,200).

Example (4). In 1962, C acquires property 1, an item of new section 38 property with a basis of $12,000 and a useful life of eight years or more. He is allowed a credit under section 38 of $840 (7 percent of $12,000) with respect to such property. In 1968, C acquires property 2 (an item of used section 38 property) by trading in property 1 and by paying an additional amount in cash. Section 47(a) applies to the disposition of property 1 and C's tax liability for 1968 is increased by $280. Since the application of section 47(a) results in an increase in tax, for purposes of computing qualified investment the cost of property 2 is not reduced by any part of the adjusted basis of the property traded in.

(c) *Dollar limitation*—(1) *In general.* Section 48(c)(2) provides that the aggregate cost of used section 38 property which may be taken into account for any taxable year in computing qualified investment under section 46(c)(1)(B) shall not exceed $50,000. If the total cost of used section 38 property exceeds $50,000, there must be selected, in the manner provided in subparagraph (4) of this paragraph, the particular items of used section 38 property the cost of which is to be taken into account in computing qualified investment. The cost of used section 38 property that may be taken into account by a person in applying the $50,000 limitation for any taxable year includes not only the cost of used section 38 property placed in service by such person during such taxable year, but also the cost of used section 38 property apportioned to such person. For purposes of this section, the cost of used section 38 property apportioned to any person means the cost of such property apportioned to him by a trust, estate, or electing small business corporation (as defined in section 1371(b)), and his share of the cost of partnership used section 38 property, with respect to the taxable year of such trust, estate, corporation or partnership ending with or within such person's taxable year. Thus, if an individual places in service during his taxable year used section 38 property with a cost of $25,000, if the cost of used section 38 property apportioned to him by an electing small business corporation for such year is $30,000, and if his share for such year of the cost of used section 38 property placed in service by a partnership is $20,000, he may select from the used section 38 property with a total cost of $75,000 the particular used section 38 property the cost of which he wishes to take into account. No part of the excess of $25,000 ($75,000 cost minus $50,000 annual limitation) may be taken into account in any other taxable year. For determining the amount of the cost to be apportioned by an electing small business corporation, see paragraph (a)(2) of § 1.48-5; in the case of estates and trusts, see paragraph (a)(2) of § 1.48-6. See paragraph (e) of this section for application of $50,000 limitation in the case of affiliated groups.

(2) *Married individuals filing separate returns.* In the case of a husband or wife who files a separate return, the aggregate cost of used section 38 property which may be taken into account for the taxable year to which such return relates cannot exceed $25,000. The preceding sentence shall not apply, however, unless the taxpayer's spouse places in service (or is apportioned the cost of) used section 38 property for the taxable year of such spouse which ends with or within the taxpayer's taxable year. Thus, if a husband and wife who file separate returns on a calendar year basis both place in service used section 38 property during the taxable year, the maximum cost of used section 38 property which may be taken into account by each is $25,000. However, in such case, if only one spouse places in service (or

is apportioned the cost of) used section 38 property during the taxable year, such spouse may take into account a maximum of $50,000 for such year. The determination of whether an individual is married shall be made under the principles of section 143 and the regulations thereunder.

(3) *Partnerships.* In the case of a partnership, the aggregate cost of used section 38 property placed in service by the partnership (or apportioned to the partnership) which may be taken into account by the partners with respect to any taxable year of the partnership may not exceed $50,000. If such aggregate cost exceeds $50,000, the partnership must make a selection in the manner provided in subparagraph (4) of this paragraph. The $50,000 limitation applies to each partner, as well as to the partnership.

(4) *Selection of $50,000 cost.* (i) If the sum of (*a*) the cost of used section 38 property placed in service during the taxable year by any person, (*b*) such person's share of the cost of partnership used section 38 property placed in service during the taxable year of a partnership ending with or within such person's taxable year, and (*c*) the cost of used section 38 property apportioned to such person for such taxable year by an electing small business corporation, estate, or trust, exceeds $50,000, such person must make a selection for such taxable year in the manner provided in subdivision (ii) of this subparagraph.

(ii) For purposes of computing qualified investment (or, in the case of a partnership, electing small business corporation, estate, or trust, for purposes of selecting used section 38 property the cost of which may be taken into account by the partners, shareholders, or estate or trust and its beneficiaries) any person to whom subdivision (i) of this subparagraph applies must select a total cost of $50,000 from (*a*) the cost of specific used section 38 property placed in service by such person, (*b*) such person's share of the cost of specific used section 38 property placed in service by a partnership and (*c*) the cost of used section 38 property apportioned to such person by an electing small business corporation, estate, or trust. When a particular property is selected, the entire cost (or entire share of cost of a particular property in the case of partnership property) of such property must be taken into account unless, as a result of the selection of such particular property, the $50,000 limitation is exceeded. Likewise, in the case of an apportionment from an electing small business corporation, estate, or trust, when the cost in a particular useful life category is selected, the entire cost in such category must be taken into account unless, as a result of the selection of such cost, the $50,000 limitation is exceeded. Thus, if a person places in service during the taxable year three items of used section 38 property, each with a cost of $20,000, he must select the entire cost of two of the items and only $10,000 of the cost of the third item; he may not select a portion of the cost of each of the three items. The selection by any person shall be made by taking the cost of used section 38 property into account in computing qualified investment (or in selecting the used section 38 property the cost of which may be taken into account by the partners, etc.), and if such property was placed in service by such person, he must maintain records which permit specific identification of any item of used section 38 property selected.

(5) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). H, who operates a sole proprietorship, purchases and places in service in 1963 used section 38 property with a cost of $60,000. His spouse, W, is a shareholder in an electing small business corporation which purchases and places in service during its fiscal year ending June 30, 1963, used section 38 property with a cost of $50,000. Both spouses file separate returns on a calendar year basis. W, as a 60 percent shareholder on the last day of the taxable year of the corporation, is apportioned $30,000 (60 percent of $50,000) of the cost of the used section 38 property placed in service by the corporation. The cost of used section 38 property that may be taken into account by H on his separate return is $25,000. The cost of used section 38 property that may be taken into account by W on her separate return is $25,000. On the other hand, if the corporation had made no investment in used section 38 property, H could take $50,000 of the $60,000 cost into account.

Example (2). Partners X, Y, and Z share the profits and losses of partnership XYZ in the ratio of 50 percent, 30 percent, and 20 percent, respectively. The partnership and each partner make returns on the basis of the calendar year. Each partner also operates a sole proprietorship. In 1963, the partnership and the partners purchase and place in service the following used section 38 property:

Property	Estimated useful life (years)	Cost
Partnership XYZ		
Property No. 1	9	$10,000
Property No. 2	7	50,000
Property No. 3	7	50,000
Property No. 4	5	30,000
Partner X		
Property No. 5	6	30,000
Partner Y		
Property No. 6	10	60,000
Partner Z		
Property No. 7	4	36,000

(i) *Selection by partnership.* In accordance with subparagraph (4)(ii) of this paragraph, the partnership selects property No. 1 and $40,000 of the cost of property No. 2 to be taken into account. Therefore, each partner's share of cost of the property selected by the partnership is as follows:

Property No.	Estimated useful life (years)	Selected cost	Partner's share of cost		
			X (50%)	Y (30%)	Z (20%)
1	9	$10,000	$5,000	$3,000	$2,000
2	7	40,000	20,000	12,000	8,000
Total		50,000	25,000	15,000	10,000

(ii) *Selection by partners.* In accordance with subparagraph (4)(ii) of this paragraph, the partners make the following selections: Partner X selects property No. 5 ($30,000), his share of the cost of property No. 1 ($5,000), and $15,000 of his share of the cost of property No. 2. Partner Y selects $50,000 of the cost of property No. 6, and no part of his share of the cost of partnership property. Partner Z, having an aggregate cost of used section 38 property of only $46,000 (partnership property of $10,000 and individually owned property of $36,000), takes into account the entire $46,000.

(iii) *Qualified investment of partner X.* X's total qualified investment in used section 38 property for 1963 is $35,000, computed as follows:

Property No.	Estimated useful life (years)	Selected cost	Applicable percentage	Qualified investment
1	9	$5,000	100	$5,000
2	7	15,000	66⅔	10,000
5	6	30,000	66⅔	20,000
Total		50,000		35,000

(iv) *Qualified investment of partner Y.* Y's total qualified investment in used section 38 property for 1963 is $50,000 (100 percent of $50,000) since he selected $50,000 of the cost of property No. 6 which has a useful life of 8 years or more.

(v) *Qualified investment of partner Z.* Z's total qualified investment in used section 38 property for 1963 is $19,333, computed as follows:

Property No.	Estimated useful life (years)	Selected cost	Applicable percentage	Qualified investment
1	9	$2,000	100	$2,000
2	7	8,000	66⅔	5,333
7	4	36,000	33⅓	12,000
Total		46,000		19,333

(d) *Dollar limitation for component members of a controlled group—(1) In general.* (i) Section 48(c)(2)(C) provides that the $50,000 limitation on the cost of used section 38 property which may be taken into account for any taxable year shall, in the case of component members of a controlled group (as defined in subparagraph (4) of this paragraph) on a particular December 31, be reduced for each such member by apportioning the $50,000 amount among such component members for their taxable years that include such December 31 in accordance with their respective amounts of used section 38 property which may be taken into account, that is, in accordance with the total cost of used section 38 property placed in service by each such member during its taxable year (without regard to the $50,000 limitation or the applicable percentages to be applied in computing qualified investment).

(ii) Except as otherwise provided in this paragraph, the $50,000 amount shall be apportioned among those corporations which are component mem-

bers of the controlled group on a December 31. For the taxable year of each such member which includes such December 31, the cost of used section 38 property taken into account in computing qualified investment under section 46(c)(1)(B) shall not exceed the amount which bears the same ratio to $50,000 as the cost of used section 38 property placed in service by such member for such taxable year bears to the total cost of used section 38 property placed in service by all component members of the controlled group for their taxable years which include such December 31.

(iii) If a component member of the group makes its income tax return on the basis of a 52-53-week taxable year, the principles of section 441(f)(2)(A)(ii) and paragraph (b)(1) of § 1.441-2 apply in determining the last day of such a taxable year.

(2) *Statement by the "filing member".* For purposes of this paragraph, the term "filing member" with respect to a particular December 31 means the member (or members) of a controlled group which has, among those members of the group which are apportioned part of the $50,000 amount for their taxable years which include such December 31, the taxable year including such December 31 which ends on the earliest date. The filing member of the group shall attach to its income tax return a statement containing the name, address, and employer identification number of each component member of the controlled group on such December 31 and a schedule showing the computation of the apportionment of the $50,000 amount among the component members of the group. Each such other member shall retain as part of its records a copy of the statement containing the apportionment schedule. Except as otherwise provided in subparagraph (3)(ii) of this paragraph, each member which is apportioned part of the $50,000 amount shall take such apportioned amount into account in filing its return for its taxable year which includes such December 31.

(3) *Estimate of used section 38 property to be placed in service.* (i) For purposes of subparagraphs (1) and (2) of this paragraph, if on the date (including extensions of time) for filing the income tax return of the filing member of the group with respect to a particular December 31, the total cost of used section 38 property actually placed in service by any component member of the group during such member's taxable year that includes such December 31 is not known, then such member shall estimate such cost. The estimate shall be made on the basis of the facts and circumstances known as of the time of the estimate. Any such estimate shall also be used in determining the total cost of used section 38 property placed in service by all component members for their taxable years including such December 31.

(ii) If an estimate is used by any component member of a controlled group pursuant to subdivision (i) of this subparagraph, each member may later file an original or amended return in which the apportionment of the $50,000 amount is based upon the cost of used section 38 property actually placed in service by all component members of the group during their taxable year which include such December 31. Such amended apportionment shall be made only if each component member of the group whose limitation would be changed files an original or amended return which reflects the amended apportionment based upon the cost of the used section 38 property actually placed in service by component members of the group. In such case, the new statement reflecting the amended apportionment shall be attached to the amended return of the filing member of the group, and a copy of such statement shall be retained by each such member pursuant to the requirements of subparagraph (2) of this paragraph.

(4) *Definitions of controlled group of corporations and component member of controlled group.* For purposes of this section, the terms "controlled group of corporations" and "component member" of a controlled group of corporations shall have the same meaning assigned to those terms in section 1563 (a) and (b), except that the phrase "more than 50 percent" shall be substituted for the phrase "at

least 80 percent" each place it appears in section 1563(a)(1). For purposes of applying § 1.1563-1(b)(2)(ii)(c), an electing small business corporation shall be treated as an excluded member whether or not it is subject to the tax imposed by section 1378.

(5) *Members of controlled group filing a consolidated return.* For the purpose of apportioning the $50,000 amount in the case of component members of a controlled group which join in filing a consolidated return, all such members shall be treated as though they were a single component member of the controlled group. Thus, in determining the limitation on the cost of used section 38 property which may be taken into account by the group filing the consolidated return, the apportionment provided in subparagraph (1)(ii) of this paragraph shall be made by using the aggregate cost of such property placed in service by all members of the group filing the consolidated return. If all component members of the controlled group join in filing a consolidated return, the group may select the items to be taken into account to the extent of an aggregate cost of $50,000; if some component members of the controlled group do not join in filing the consolidated return, then the members of the group which join in filing the consolidated return may select the items to be taken into account to the extent of the amount apportioned to such members under subparagraph (1)(ii) of this paragraph.

(6) *Examples.* This paragraph may be illustrated by the following examples:

Example (1). (i) On December 31, 1970, corporations M, N and O are component members of the same controlled group. The taxable years of M, N, and O end, respectively, on January 31, March 31, and April 30. During the respective taxable years of each corporation which include December 31, 1970, M places in service no used section 38 property, and N and O place in service used section 38 property with respective costs of $100,000 and $150,000. N is the "filing member" of the group since N, among the members (N and O) which are apportioned part of the $50,000 amount for their taxable years which include such December 31, has the taxable year ending on the earliest date.

(ii) The cost of used section 38 property taken into account by N for its taxable year ending March 31, 1971, may not exceed $20,000, that is, an amount which bears the same ratio to $50,000 as the cost of used section 38 property placed in service by N for its taxable year ($100,000) bears to the total cost of used section 38 property placed in service by all component members of the controlled group (M, N, and O) for their taxable years which include December 31, 1970 ($250,000). Similarly, the cost of used section 38 property taken into account by O for its taxable year ending April 30, 1971, may not exceed $30,000.

Example (2). (i) On December 31, 1971, corporations S and T are component members of the same controlled group. The taxable years of corporations S and T end, respectively, on January 31 and June 30. On April 15, 1972, S files an income tax return for its taxable year ending January 31, 1972, during which year it places in service used section 38 property costing $100,000. T estimates that it will place in service used section 38 property costing $150,000 during its taxable year ending June 30, 1972.

(ii) S, the "filing member" of the group, must file an apportionment schedule under which it may take into account as the cost of used section 38 property an amount not in excess of $20,000 ($100,000/$250,000 × $50,000). If T actually places in service during its taxable year used section 38 property costing more or less than $150,000, its income tax return for its taxable year ending June 30, 1972, may reflect the amended apportionment of the $50,000 limitation based upon the cost of used section 38 property actually placed in service by the group, provided that S attaches a new apportionment schedule to an amended return to reflect the amended apportionment. For example, if T places in service used section 38 property costing $200,000, the cost of used section 38 property taken into account by S and T for their respective taxable years could not exceed $16,667 ($100,000/$300,000 × $50,000) and $33,333 ($200,000/$300,000 × $50,000), respectively, under an amended apportionment.

[T.D. 6731, 29 FR 6076, May 8, 1964, as amended by T.D. 7181, 37 FR 8064, Apr. 25, 1972]

§ 1.48-4 Election of lessor of new section 38 property to treat lessee as purchaser.

(a) *In general*—(1) *Lessee treated as purchaser.* Under section 48(d), a lessor of property may elect to treat the lessee of such property as having purchased such property (or, in the case of short-term lease property de-

scribed in subparagraph (2) of this paragraph, a portion of such property) for purposes of the credit allowed by section 38 if the following conditions are satisfied:

(i) The property must be "section 38 property" in the hands of the lessor; that is, it must be property with respect to which depreciation (or amortization in lieu of depreciation) is allowable to the lessor, it must have a useful life of 3 years (4 years in the case of property which is not described in section 50) or more in his hands, and in every other respect it must meet the requirements of § 1.48-1. Thus, for example, property leased by a municipality to a taxpayer for use in what is commonly known as an "industrial park" is not eligible for the election since, under paragraph (k) of § 1.48-1, property used by a governmental unit is not section 38 property. In addition, property used by the lessee predominantly outside the United States is not eligible for the election since, under paragraph (g) of § 1.48-1, such property is not section 38 property. For purposes of this subdivision, if the lessor is an estate or trust, depreciation (or amortization in lieu of depreciation) will be considered allowable to the estate or trust even if it is apportioned to the beneficiaries or other persons.

(ii) The property must be "new section 38 property" (within the meaning of § 1.48-2) in the hands of the lessor, and the original use of such property must commence with the lessor. See paragraph (b) of this section for the application of the rules relating to "original use" in the case of leased property.

(iii) The property would constitute "new section 38 property" to the lessee if such lessee had actually purchased the property. Thus, the election is not available if the lessee is not the original user of the property. See paragraph (b) of this section for the application of the rules relating to "original use" in the case of leased property. See paragraph (d) of this section for the determination of the estimated useful life of leased property in the hands of the lessee.

(iv) A statement of election to treat the lessee as a purchaser has been filed in the manner and within the time provided in paragraph (f) or (g) of this section.

(v) The lessor is not a person referred to in section 46(d)(1), that is, a mutual savings bank, cooperative bank, or domestic building and loan association to which section 593 applies; a regulated investment company or real estate investment trust subject to taxation under subchapter M, chapter 1 of the Code; or a cooperative organization described in section 1381(a).

The election may be made on a property-by-property basis or a general election may be made with respect to each taxable year of a particular lessee. If the conditions of this subparagraph have been met, the lessee shall be treated as though he were the actual owner of all or a portion of the property for purposes of the credit allowed by section 38. Thus, the lessee shall be entitled to a credit allowed by section 38 with respect to such property for the taxable year in which he places such property in service, and the lessor shall not be entitled to a credit allowed by section 38 with respect to such property unless the property is short-term lease property (as defined in subparagraph (2) of this paragraph). Moreover, if the leased property is disposed of, or if it otherwise ceases to be section 38 property, the property will be subject to the provisions of section 47 (relating to early dispositions, etc.).

(2) *Short-term lease property.* For purposes of this section, the term "short-term lease property" means property which—

(i) Is new section 38 property;

(ii) Has a class life (determined under section 167(m)) in excess of 14 years;

(iii) Is leased under a lease entered into after November 8, 1971, for a period which is less than 80 percent of the class life of such property; and

(iv) Is not leased subject to a net lease within the meaning of section 57(c)(1)(B) and the regulations thereunder.

The class life of property shall be determined under section 167(m) and the regulations prescribed in connection with that section, except that such

class life shall be determined without regard to any variance from the class life permitted under such section. If a class life has not been prescribed for property under section 167(m) on the date such property is leased, the class life of the property shall be the estimated useful life used to compute the allowance for depreciation with respect to such property under section 167. For purposes of subdivision (iii) of this subparagraph, the period for which a lease is entered into shall be determined without regard to any option on the part of the lessee to extend or renew such lease, and without regard to any option on the part of the lessee to cancel the lease after a specified period if under the terms of such lease, such a cancellation would result in the imposition of a substantial penalty upon the lessee. Generally, a penalty equal to 25 percent of the total remaining rental payments due under the lease will be regarded as substantial.

(b) *Original use.* For purposes of this section only, the lessor and the lessee may both be considered as the original users of an item of leased property. The determination of whether the lessor qualifies as the original user of leased property shall be made under paragraph (b)(7) of § 1.48-2. The determination of whether the lessee qualifies as the original user of leased property shall be made, under paragraph (b)(7) of § 1.48-2, as if the lessee actually purchased the property. Thus, the lessee would not be considered the original user of the property if it has been previously used by the lessor or another person, or if it is reconstructed, rebuilt, or reconditioned property. However, the lessee would be considered the original user if he is the first person to use the property for its intended function. Thus, the fact that the lessor may have, for example, tested, stored, or attempted to lease the property to other persons will not preclude the lessee from being considered the original user.

(c) *Qualified investment*—(1) *In general.* If a valid election is made under this section, the amount of qualified investment under section 46(c) with respect to the leased property shall be determined under this paragraph and paragraphs (d) and (e) of this section.

(2) *Nonshort-term lease property.* In the case of property which is not short-term lease property, the lessee is treated as having acquired the entire property for an amount equal to—

(i) The fair market value of such property on the date possession is transferred to the lessee, or

(ii) If the property is leased by a component member of a controlled group to another component member of the same controlled group (within the meaning of paragraph (f)(4) of § 1.46-1) on the date possession of the property is transferred to the lessee, the basis of the property in the hands of the lessor.

(3) *Short-term lease property.* (i) In the case of short-term lease property, the lessee is treated as having acquired a portion of such property. The amount for which the lessee is treated as having acquired such portion is an amount equal to a fraction, the numerator of which is the term of the lease and the denominator of which is the class life of the property leased, of the amount for which the lessee would be treated as having acquired the property under subparagraph (2) of this paragraph if the property were not short-term lease property.

(ii) In the case of short-term lease property, the qualified investment of the lessor is an amount equal to his qualified investment in such property determined under section 46(c) multiplied by a fraction, the numerator of which is the class life of the property leased minus the term of the lease and the denominator of which is the class life of such property.

(4) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. (a) On December 1, 1971, X corporation completed construction of an item of new section 38 property with a basis of $10,000. Under section 167(m), the property has a class life of 16 years. On December 1, 1971, X leases the property to individual A for 4 years and A immediately places the property in service. The lease is not a net lease within the meaning of section 57(c)(1)(B). On the date of the lease, the fair market value of the property is $12,000. The property would qualify as new section

38 property in A's hands if it had been purchased by A. Under this section, the property is short-term lease property. X makes the election under this section to treat A as having acquired a portion of the property.

(b) A is treated as having acquired from X a portion of the property for $3,000 (the fair market value of the property, $12,000, multiplied by a fraction, 4/16, the numerator of which is the term of the lease and the denominator of which is the class life of the leased property). Since under paragraph (d) of this section the useful life of such property in the hands of A is the same as the useful life of such property in the hands of X, and such useful life is at least 7 years, A's qualified investment with respect to the property is $3,000.

(c) The qualified investment of X is $7,500 (the qualified investment of X under section 46(c), $10,000, multiplied by a fraction, 12/16, the numerator of which is the class life of the leased property, 16, minus the term of the lease, 4, and the denominator of which is the class life of the property).

(d) *Estimated useful life of leased property.* The estimated useful life to the lessee of property subject to the election shall be deemed to be the estimated useful life in the hands of the lessor for purposes of computing depreciation, regardless of the term of the lease. The lessor shall determine the estimated useful life of each leased property on an individual basis even though multiple asset accounts are used. However, in the case of assets similar in kind contained in a multiple asset account, the lessor shall assign to each of such assets the average useful life of such assets used in computing depreciation. Thus, for example, if during a taxable year a lessor leases 10 similar trucks with an average estimated useful life for depreciation purposes of 6 years, based on an estimated range of 5 to 7 years, he must assign a useful life of 6 years to each of the 10 trucks.

(e) *Lessor itself a lessee*—(1) *In general.* If the lessee of property is treated, under this section, as having purchased all or a portion of such property and if such lessee leases such property to a sublessee, the qualified investment with respect to such property in the hands of the sublessee shall be determined under paragraphs (c) and (d) of this section as if the original lessor had leased the property directly to the sublessee for the term of the sublessee's lease on the date possession of the property is transferred to the sublessee. For this purpose, property which is short-term lease property in the hands of the lessee shall be treated as short-term lease property in the hands of the sublessee regardless of whether such property is leased to the sublessee subject to a net lease (within the meaning of section 57(c)(1)(B)). In the case of property which is short-term lease property in the hands of the sublessee, the amount for which the lessee is treated as having acquired such property under paragraph (c) of this section shall be reduced by an amount equal to such amount multiplied by a fraction, the numerator of which is the term of the lease of the sublessee and the denominator of which is the term of the lease of the lessee.

(2) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. (a) On December 1, 1971, corporation X completes construction of a machine at a cost of $10,000. The machine has a class life under section 167(m) of 20 years. On December 1, 1971, X leases the machine to corporation Y for 12 years, and Y immediately subleases the machine to individual A for 8 years. X and Y are component members of the same controlled group. The lease between X and Y is not a net lease within the meaning of section 57(c)(1)(B). The fair market value of the property on December 1, 1971, is $16,000. Both X and Y make valid elections under this section.

(b) The property is short-term lease property and this paragraph applies.

(c) The qualified investment of A is $6,400. Such amount is determined by multiplying $16,000, the amount for which A would be treated under paragraph (c)(2) of this section as having acquired the property if it were not short-term lease property, by 8/20.

(d) The qualified investment of Y is $2,000. Such amount is determined by multiplying $10,000, the amount for which Y would be treated under paragraph (c)(2) of this section as having acquired the property if it were not short-term lease property, by 12/20, and by reducing the amount so determined ($6,000) by 8/12 of such amount ($4,000) to $2,000.

(e) The qualified investment of X is $4,000. Such amount is determined by multiplying the amount of X's qualified investment determined under section 46(c) without regard to this section ($10,000) by 8/20.

(f) *Property-by-property election*—(1) *Manner of making election.* The election of a lessor with respect to a particular property (or properties) shall be made by filing a statement with the lessee, signed by the lessor and including the written consent of the lessee, containing the following information:

(i) The name, address, and taxpayer account number of the lessor and the lessee;

(ii) The district director's office with which the income tax returns of the lessor and the lessee are filed;

(iii) A description of each property with respect to which the election is being made;

(iv) The date on which possession of the property (or properties) is transferred to the lessee;

(v) The estimated useful life category of the property (or properties) in the hands of the lessor, that is, 3 years or more but less than 5 years, 5 years or more but less than 7 years, or 7 years or more;

(vi) The amount for which the lessee (or sublessee) is treated as having acquired the leased property under paragraph (c)(2) or (3) of this section; and

(vii) If the lessor is itself a lessee, the name, address, and taxpayer account number of the original lessor, and the district director's office with which the income tax return of such original lessor is filed.

(2) *Time for making election.* The statement referred to in subparagraph (1) of this paragraph shall be filed with the lessee on or before the due date (including any extensions of time) of the lessee's return for the lessee's taxable year during which possession of the property is transferred to the lessee, except that if such taxable year ends after March 31, 1971, and before December 11, 1971, the statement shall be filed with the lessee on or before the due date (including any extensions of time) of the lessee's return for such taxable year, or on or before October 24, 1972, whichever is later.

(3) *Election is irrevocable.* An election under this paragraph shall be irrevocable as of the time the statement referred to in subparagraph (1) of this paragraph is filed with the lessee.

(g) *General election*—(1) *In general.* In lieu of making elections on a property-by-property basis in the manner and time prescribed in paragraph (f) of this section, a lessor may, with respect to a particular taxable year of a particular lessee, make a general election to treat such lessee as having purchased all properties possession of which is transferred under lease by the lessor to the lessee during such taxable year of the lessee.

(2) *Manner and time for making general election.* The general election of a lessor with respect to a taxable year of a lessee shall be made by filing a statement with the lessee, signed by the lessor and including the written consent of the lessee, on or before the due date (including any extensions of time) of the lessee's return for such taxable year, except that if such taxable year ends after March 31, 1971, and before December 11, 1971, the statement shall be filed with the lessee on or before the due date (including any extensions of time) of the lessee's return for such taxable year, or on or before October 24, 1972, whichever is later. Such statement of general election shall contain:

(i) The name, address, and taxpayer account number of the lessor and the lessee;

(ii) The taxable year of the lessee with respect to which such general election is made;

(iii) The district director's office with which the income tax returns of the lessor and the lessee are filed;

(iv) If the lessor is itself a lessee, the name, address, and taxpayer account number of the original lessor, and the district director's office with which the income tax return of such original lessor is filed.

(3) *Election is irrevocable.* A general election under this paragraph shall be irrevocable as of the time the statement referred to in subparagraph (2) of this paragraph is filed with the lessee and shall be binding on the lessor and the lessee for the entire taxable year of the lessee with respect to which such general election is made.

(4) *Information requirement.* If a lessor, with respect to a taxable year of the lessee, makes a general election

under this paragraph, such lessor shall provide such lessee, on or before the date required for filing the statement under subparagraph (2) of this paragraph, with a statement (or statements) containing the information required by paragraph (f)(1) (iii), (iv), (v), and (vi) of this section with respect to all properties possession of which is transferred under lease by the lessor to the lessee during such taxable year.

(h) *Signature.* The statement referred to in paragraph (f)(1) or (g)(2) of this section shall not be valid unless signed by both the lessor and the lessee. The signature of the lessee shall constitute the consent of the lessee to the election. The statement shall be signed by the taxpayer or a duly authorized agent of the taxpayer. For purposes of this section, a facsimile signature may be used in lieu of a signature manually executed and, if used, shall be as binding as a signature manually executed.

(i) [Reserved]

(j) *Record requirements.* The lessor and the lessee shall keep as a part of their records the statement referred to in paragraph (f)(1), or the statements referred to in paragraphs (g)(2) and (g)(4), of this section. The lessor shall attach to his income tax return a summary statement of all property leased during his taxable year with respect to which an election is made. In the case of a taxable year ending after March 31, 1971, and before December 11, 1971, a summary statement may be filed on or before the due date (including any extensions of time) of the return or on or before October 24, 1972, whichever is later, with the Internal Revenue Service Center with which the return has been filed. Such summary statement shall contain the following information: (1) The name, address, and taxpayer account number of the lessor; and (2) in numerical account number order, each lessee's account number, name, and address, the estimated useful life category of the property (or, if applicable, the estimated useful life expressed in years), and the basis or fair market value of the property, whichever is applicable.

(k) *Adjustment of rental deductions*—(1) *In general.* The rules of this paragraph apply only to section 38 property placed in service before January 1, 1964, and with respect to any such property only for taxable years of a lessee beginning before January 1, 1964. If a lessor makes a valid election under this section with respect to property placed in service by the lessee before January 1, 1964, section 48(g) and § 1.48-7 (relating to adjustments to basis of property) shall not apply to the lessor with respect to such property. Thus, the lessor is not required to reduce under section 48(g)(1) the basis of such property. However, if such an election is made, the deductions otherwise allowable under section 162 to the lessee for amounts paid or accrued to the lessor under the lease shall be adjusted in the manner provided in this paragraph. For special adjustment for taxable years beginning after December 31, 1963, see paragraph (m) of this section.

(2) *Decrease in rental deduction.* (i) The deductions otherwise allowable under section 162 to the lessee for amounts paid or accrued to the lessor under the lease with respect to leased property placed in service before January 1, 1964, shall be decreased under subdivision (ii) or (iii) of this subparagraph, whichever is applicable, by an amount determined by reference to the credit earned on the leased property. The "credit earned" on the leased property is determined by multiplying the qualified investment (as defined in section 46(c)) with respect to such property by 7 percent. Thus, the credit earned (and the decrease in deductions) is determined without regard to the limitation based on tax which, under section 46(a)(2), may limit the amount of the credit the lessee may take into account in any one year.

(ii) If, in the case of property placed in service before January 1, 1964, the lessor, under paragraph (f)(1)(v) of this section, supplies the lessee with the useful life of such property expressed in years, then for each taxable year beginning before January 1, 1964, any part of which falls within a period beginning with the month in which the leased property is placed in service by the lessee and ending with the close of the estimated useful life of

such property (as determined under paragraph (d) of this section), the lessee shall decrease the deduction otherwise allowable under section 162 for each such taxable year with respect to such property. The decrease for each such taxable year shall be equal to (*a*) the credit earned, divided by (*b*) the estimated useful life of the property (expressed in months), multiplied by (*c*) the number of calendar months in which the leased property was held by the lessee during such taxable year. Thus, if leased property with a basis of $27,000 in the hands of a calendar-year lessee, and with an estimated useful life of 10 years, is placed in service by the lessee on July 15, 1963, the lessee must decrease his section 162 deduction with respect to the leased property for the taxable year 1963 by $94.50 ($1,890 credit earned, divided by 120, multiplied by 6).

(iii) If, in the case of property placed in service before January 1, 1964, the lessor, under paragraph (f)(1)(v) of this section, supplies the lessee with the useful life category of such property, then for each taxable year beginning before January 1, 1964, during a period equal to the shortest life of the useful life category used by the lessee in computing qualified investment under section 46(c) with respect to the leased property, the lessee shall decrease the deduction otherwise allowable under section 162 for such taxable year with respect to such property. The decrease for each such taxable year shall be equal to the credit earned divided by such shortest life, that is, 4, 6, or 8. Such decreases shall begin with the taxable year during which the lessee places the property in service. Thus, if leased property with a basis of $30,000 to the lessee, and an estimated useful life falling within the 4 years or more but less than 6 years useful life category, is placed in service by the lessee within the lessee's taxable year ending December 31, 1962, the lessee must decrease his section 162 deduction with respect to the leased property for each of the taxable years 1962 and 1963 by $175 ($700 credit earned divided by 4).

(iv) To the extent that a required decrease, under subdivision (ii) or (iii) of this subparagraph, is not taken into account for any taxable year beginning before January 1, 1964, because the deduction otherwise allowable under section 162 for such taxable year with respect to the leased property is less than the required decrease for such taxable year, then the balance of the required decrease not taken into account for such taxable year shall decrease the amount otherwise allowable as a deduction under section 162 with respect to such property for the next succeeding taxable year (or years) beginning before January 1, 1964, if any, for which a deduction is allowable with respect to such property. Thus, if the required decrease with respect to leased property is $200 for 1962 but the lessee's deduction otherwise allowable under section 162 for such taxable year with respect to such property is only $50, the balance of $150 must be applied in 1963 to decrease the deduction otherwise allowable to the lessee with respect to the leased property for such taxable year.

(v) See paragraph (b) of § 1.48-7 for reduction of basis in the case of an actual purchase of leased property by a lessee (in a taxable year of such lessee beginning before January 1, 1964) who has been treated as a purchaser of such property under this section.

(3) *Increase in rental deductions on account of early disposition, etc.* (i) If, as a result of an early disposition, etc., in a taxable year beginning before January 1, 1964, with respect to leased property placed in service before such date, the lessee's tax is increased under section 47(a)(1) or (2), or an adjustment in a carryback or carryover is made under section 47(a)(3) by reduction of an unused credit, the rental deductions (if any) otherwise allowable under section 162 to such lessee for amounts paid or accrued to the lessor under the lease with respect to such property shall be increased in an amount equal to the total decreases previously made in the lessee's rental deductions under subparagraph (2) of this paragraph.

(ii) Except as provided in subdivision (iii) of this subparagraph, the increase in rental deductions described in sub-

division (i) of this subparagraph shall be taken into account as an increase in rental deductions otherwise allowable under section 162 for the taxable year in which the early disposition, etc., occurred.

(iii) If, after the event which caused section 47(a) (1), (2), or (3) to apply the lessee continues the use of the property in a trade or business or in the production of income, the increase in rental deductions described in subdivision (i) of this subparagraph shall be taken into account ratably over the remaining portion of the useful life of the property which was used in making the decreases in rental deductions with respect to the property under subparagraph (2) of this paragraph.

(iv) If subdivision (iii) of this subparagraph applies, and if, prior to the expiration of the useful life of the property used in making the decreases in rental deductions, the lease is terminated other than by actual purchase of the property by the lessee, any increase in rental deductions not previously taken into account shall be taken into account as an increase in rental deductions for the taxable year in which the lease is terminated. In the case of an actual purchase of the property by the lessee, see paragraph (e) of § 1.48-7.

(l) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). X Corporation is engaged in the business of manufacturing and leasing new and reconstructed equipment which in its hands has an estimated useful life of 12 years. After December 31, 1961, X Corporation constructs machine no. 1 at a cost of $20,000 and reconstructs machine no. 2 at a cost of $5,000. On February 15, 1962, Y Corporation, a calendar-year taxpayer, leases both machines from X Corporation and places them in service. The fair market value of machine no. 1 on the date on which possession is transferred to Y is $25,200. Machine no. 1 would qualify as new section 38 property in Y's hands if it had been purchased by Y. If X elects to treat Y as the purchaser of machine no. 1, under paragraph (c)(2)(ii) of this section such machine will have a basis of $25,200 in Y's hands. Under paragraph (f)(1)(v) of this section, X supplies Y with an estimated useful life of 12 years (expressed in years rather than useful life category) with respect to machine no. 1 for purposes of determining Y's qualified investment. Y's credit earned with respect to the property is $1,764 (7 percent of $25,200). Under paragraph (k)(2)(ii) of this section, Y's deduction attributable to the leased property for 1962 will be decreased by $134.75 (credit earned of $1,764, divided by 144, multiplied by 11), and for 1963 such deduction will be decreased by $147 ($1,764, divided by 144, multiplied by 12). The election is not available with respect to machine no. 2 since a reconstructed machine would not constitute new section 38 property if Y had purchased it. In such case, while X cannot make the election to treat Y as a purchaser, X would be entitled to a credit under section 38 based on its expenditure of $5,000 as an investment in new section 38 property, since such amount represents cost of reconstruction after December 31, 1961.

Example (2). Assume the same facts as in example (1) except that under paragraph (f)(1)(v) of this section, X supplies Y with an estimated useful life category of 8 years or more (rather than an estimated useful life expressed in years) with respect to machine no. 1 for purposes of determining Y's qualified investment. Under paragraph (k)(2)(iii) of this section, Y's deduction attributable to the leased property will be decreased by $220.50 (credit earned of $1,764, divided by 8) for each of its taxable years 1962 and 1963.

Example (3). Assume the same facts as in example (1) except that the lessee disposes of his interest in the lease on January 1, 1963, and that there is an increase in Y's tax for 1963 under section 47(a)(1) in the amount of $1,764. Under paragraph (k)(2) of this section, Y's deductions attributable to the leased property are decreased only in 1962, and the amount of such decrease is $134.75. In 1963 there shall be an increase of $134.75 in the deductions otherwise allowable under section 162 for such taxable year with respect to the leased property.

Example (4). Assume the same facts as in example (1) except that during the year 1963 the property was used by Y predominantly outside the United States within the meaning of paragraph (g) of § 1.48-1, and thereafter was used in Y's trade or business. Under paragraph (k)(3) of this section, the increase of $134.75 described in example (3) is taken into account ratably as an increase in rental deductions otherwise allowable under section 162 in the amount of $12.25 ($134.75 divided by 11 years) for 1963 and each of the 10 succeeding years.

(m) *Increase in rental deductions on account of section 203(a)(2)(B) of the Revenue Act of 1964*—(1) *In general.* (i) Under section 203(a)(2)(B) of the Revenue Act of 1964, if, for any taxable

year of a lessee beginning before January 1, 1964, the rental deductions otherwise allowable under section 162 to such lessee for amounts paid or accrued to the lessor under the lease with respect to leased property placed in service before January 1, 1964, were decreased under paragraph (k)(2) of this section, such rental deductions shall be increased.

(ii) The increase in rental deductions described in subdivision (i) of this subparagraph shall be in an amount equal to the total decreases in the lessee's rental deductions previously made under paragraph (k)(2) of this section less any increases in rental deductions made under paragraph (k)(3) of this section.

(iii) Except as provided in subdivision (iv) of this subparagraph, the increase in rental deductions described in subdivision (i) of this subparagraph shall be taken into account ratably over the remaining portion of the useful life of the property commencing with the first day of the first taxable year beginning after December 31, 1963. For this purpose, the useful life of the property shall be the useful life used in making the decreases in rental deductions with respect to the property under paragraph (k)(2) of this section.

(iv) If the lease is terminated other than by the lessee's actual purchase of the property during a taxable year beginning after December 31, 1963, and before the end of the remaining useful life of the property used in making the decreases in rental deductions, the amount of the increase in rental deductions described in subdivision (i) of this subparagraph and not previously taken into account shall be allowed as a deduction for the taxable year in which such termination occurs.

(v) The rental deductions with respect to any section 38 property are not to be increased under this paragraph if the lessee dies in a taxable year beginning before January 1, 1964.

(vi) The increase in rental deductions described in subdivision (i) of this subparagraph shall ordinarily be taken into account by the lessee treated as the purchaser, that is, the lessee entitled to the credit. However, if the property under the lease is transferred by the lessee to a successor lessee in a transaction described in section 47(b) (other than a transfer by reason of death) under which the successor lessee assumes the lessee's obligations under the lease, such increase in rental deductions shall be taken into account by the successor lessee in the manner prescribed in this paragraph.

(2) *Examples.* The operation of this paragraph may be illustrated by the following examples:

Example (1). (a) X Corporation acquired on January 1, 1962, an item of new section 38 property with a basis of $24,000 and with a useful life to the lessor of 10 years. Y Corporation, which makes its returns on the basis of a calendar year, leased such property from X Corporation and placed it in service on January 2, 1962. Under this section, X Corporation made a valid election to treat Y Corporation as having purchased such property for purposes of the credit allowed by section 38 and supplied the lessee with information that the property had a useful life of 10 years. The amount of the credit earned with respect to such property was $1,680 (7 percent of $24,000). For each of the taxable years 1962 and 1963, Y Corporation decreased, under paragraph (k)(2) of this section, its deductions otherwise allowable under section 162 with respect to such property by $168 ($1,680 multiplied by $\frac{1}{10}$).

(b) For each of the taxable years 1964 through 1971, Y Corporation increases its deductions otherwise allowable under section 162 for amounts paid to X Corporation under the lease by $42 ($336 (that is, $168 multiplied by 2) divided by the remaining useful life of 8 years).

Example (2). (a) The facts are the same as in example (1) except that the lease is terminated on January 3, 1965.

(b) For the taxable year 1964, Y Corporation increases its deductions otherwise allowable under section 162 by $42.

(c) For the taxable year 1965, Y Corporation increases its deductions otherwise allowable under section 162 for the portion of the increase which had not been taken into account as of the time of the termination of the lease. Thus, the amount of such increase for the taxable year 1965 is $294 ($336 minus $42).

(Sec. 38, 76 Stat. 963; 26 U.S.C. 38)

[T.D. 6731, 29 FR 6080, May 8, 1964; 29 FR 7671, June 16, 1964, as amended by T.D. 6838, 30 FR 9060, July 20, 1965; T.D. 7203, 37 FR 17131, 17132, Aug. 25, 1972]

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§ 1.48-5 Electing small business corporations.

(a) *In general.* (1) In the case of an electing small business corporation (as defined in section 1371(b)), the basis of "new section 38 property" and the cost of "used section 38 property" placed in service during the taxable year shall be apportioned pro rata among the persons who are shareholders of such corporation on the last day of such corporation's taxable year. Section 38 property shall not (by reason of such apportionment) lose its character as new section 38 property or used section 38 property, as the case may be. The estimated useful life of such property in the hands of a shareholder shall be deemed to be the estimated useful life of such property in the hands of the electing small business corporation. The bases of all new section 38 properties which have a useful life falling within a particular useful life category shall be aggregated; likewise, the cost of all used section 38 properties which have a useful life falling within a particular useful life category shall be aggregated. The total bases of new section 38 properties within each useful life category and the total cost of used section 38 properties within each useful life category shall be apportioned separately. The useful life categories are: (i) 3 years or more but less than 5 years; (ii) 5 years or more but less than 7 years; and (iii) 7 years or more. There shall be apportioned to each person who is a shareholder of the electing small business corporation on the last day of the taxable year of such corporation, for his taxable year in which or with which the taxable year of such corporation ends, his pro rata share of the total bases of new section 38 properties within each useful life category, and his pro rata share of the total cost of used section 38 properties within each useful life category. In determining who are shareholders of an electing small business corporation on the last day of its taxable year, the rules of paragraph (d)(1) of § 1.1371-1 and of paragraph (a)(2) of § 1.1373-1 shall apply.

(2) The total cost of used section 38 property that may be apportioned by an electing small business corporation to its shareholders for any taxable year of such corporation shall not exceed $50,000. If the total cost of used section 38 property placed in service during the taxable year by the electing small business corporation exceeds $50,000 such corporation must select, under paragraph (c)(4) of § 1.48-3, the used section 38 property the cost of which is to be apportioned to its shareholders.

(3) A shareholder to whom the basis (or cost) of section 38 property is apportioned shall, for purposes of the credit allowed by section 38, be treated as the taxpayer with respect to such property. Thus, the total cost of used section 38 property apportioned to him by the electing small business corporation must be taken into account as cost of used section 38 property in determining whether the $50,000 limitation on the cost of used section 38 property which may be taken into account by the shareholder in computing qualified investment for any taxable year is exceeded. If a shareholder takes into account in determining his qualified investment any portion of the basis (or cost) of section 38 property placed in service by an electing small business corporation and if such property subsequently is disposed of or otherwise ceases to be section 38 property in the hands of the corporation, such shareholder shall be subject to the provisions of section 47. See § 1.47-4.

(b) *Summary statement.* An electing small business corporation shall attach to its return a statement showing the apportionment to each shareholder of the total bases of new, and the total cost of used, section 38 properties within each useful life category.

(c) *Example.* This section may be illustrated by the following example:

Example. (1) X Corporation, an electing small business corporation which makes its return on the basis of the calendar year, acquires and places in service on June 1, 1962, three new assets which qualify as new section 38 property and three used assets which qualify as used section 38 property. The basis of each new, and the cost of each used, section 38 property and the estimated useful life of each property are as follows:

Asset No.	Basis (or cost)	Estimated useful life
1 (new)	$30,000	4 years.
2 (new)	30,000	4 years.
3 (new)	30,000	8 years.
4 (used)	12,000	6 years.
5 (used)	12,000	6 years.
6 (used)	12,000	8 years.

On December 31, 1962, X Corporation has 10 shares of stock outstanding which are owned as follows: A owns 3 shares, B owns 2 shares, and C owns 5 shares.

(2) Under this section, the total bases of the new, and the total cost of the used, section 38 properties are apportioned to the shareholders of X Corporation as follows:

Useful life category	New—4 to 6 years	New—8 years or more	Used—6 to 8 years	Used—8 years or more
Total bases or total cost	$60,000	$30,000	$24,000	$12,000
Shareholder A (3/10)	18,000	9,000	7,200	3,600
Shareholder B (2/10)	12,000	6,000	4,800	2,400
Shareholder C (5/10)	30,000	15,000	12,000	6,000

Assume that shareholders A, B and C did not place in service during their taxable years in which falls December 31, 1962 (the last day of X Corporation's taxable year) any section 38 property and that such shareholders did not own any interests in other electing small business corporations, partnerships, estates, or trusts. Under section 46(c), the qualified investment of shareholder A is $23,400, of shareholder B is $15,600, and of shareholder C is $39,000, computed as follows:

Basis (or cost)	Applicable percentage	Qualified investment
SHAREHOLDER A		
$18,000 (new)	33⅓	$6,000
$9,000 (new)	100	9,000
$7,200 (used)	66⅔	4,800
$3,600 (used)	100	3,600
Total		23,400
SHAREHOLDER B		
$12,000 (new)	33⅓	$4,000
$6,000 (new)	100	6,000
$4,800 (used)	66⅔	3,200
$2,400 (used)	100	2,400
Total		15,600
SHAREHOLDER C		
$30,000 (new)	33⅓	$10,000
$15,000 (new)	100	15,000
$12,000 (used)	66⅔	8,000
$6,000 (used)	100	6,000
Total		39,000

[T.D. 6731, 29 FR 6082, May 8, 1964, as amended by T.D. 6931, 32 FR 14040, Oct. 10, 1967; T.D. 7203, 37 FR 17133, Aug. 25, 1972]

§ 1.48–6 Estates and trusts.

(a) *In general.* (1) In the case of an estate or trust, the basis of "new section 38 property" and the cost of "used section 38 property" placed in service during the taxable year shall be apportioned among the estate or trust and its beneficiaries on the basis of the income of such estate or trust allocable to each. Section 38 property shall not (by reason of such apportionment) lose its character as new section 38 property or used section 38 property, as the case may be. The estimated useful life of such property in the hands of a beneficiary shall be deemed to be the estimated useful life of such property in the hands of the estate or trust. The bases of all new section 38 properties which have a useful life falling within a particular useful life category shall be aggregated; likewise, the cost of all used section 38 properties which have a useful life falling within a particular useful life category shall be aggregated. The total bases of new section 38 properties within each useful life category and the total cost of used section 38 properties within each useful life category shall be apportioned separately. The useful life categories are: (i) 3 years or more but less than 5 years; (ii) 5 years or more but less than 7 years; and (iii) 7 years or more. There shall be apportioned to the estate or trust for its taxable year, and to each beneficiary of such estate or trust for his taxable year in which or with which the taxable year of such estate or trust ends, his share (as de-

termined under paragraph (b) of this section) of the total bases of new section 38 properties within each useful life category, and his share of the total cost of used section 38 properties within each useful life category.

(2) The total cost of used section 38 property that may be apportioned among an estate or trust and its beneficiaries for any taxable year of such estate or trust shall not exceed $50,000. If the total cost of used section 38 property placed in service during the taxable year by the estate or trust exceeds $50,000, such estate or trust must select, under paragraph (c)(4) of § 1.48-3, the used section 38 property the cost of which is to be apportioned among such estate or trust and its beneficiaries.

(3) A beneficiary to whom the basis (or cost) of section 38 property is apportioned shall, for purposes of the credit allowed by section 38, be treated as the taxpayer with respect to such property. Thus, the total cost of used section 38 property apportioned to him by the estate or trust must be taken into account as cost of used section 38 property in determining whether the $50,000 limitation on the cost of used property which may be taken into account by the beneficiary in computing qualified investment for any taxable year is exceeded. If a beneficiary takes into account in determining his qualified investment any portion of the basis (or cost) of section 38 property placed in service by an estate or trust and if such property subsequently is disposed of or otherwise ceases to be section 38 property in the hands of estate or trust, such beneficiary shall be subject to the provisions of section 47. See § 1.47-5.

(4) For purposes of this section, the term "beneficiary" includes heir, legatee, and devisee.

(5) If during the taxable year of an estate or trust a beneficiary's interest in the income of such estate or trust terminates, the basis (or cost) of section 38 property placed in service by such estate or trust after such termination shall not be apportioned to such beneficiary.

(b) *Share.* A trust's, estate's, or beneficiary's share of the total bases of new section 38 properties, and the total cost of used section 38 properties, within a useful life category shall be—

(1) The total bases of new (or the total cost of used) section 38 properties which have a useful life falling within such useful life category placed in service in the taxable year of the estate or trust, multiplied by

(2) The amount of income allocable to such estate or trust or to such beneficiary for such taxable year, divided by

(3) The sum of the amounts of income allocable to such estate or trust and all its beneficiaries taken into account under subparagraph (2) of this paragraph.

(c) *Limitation based on amount of tax.* In the case of an estate or trust, the $25,000 amount specified in section 46(a)(2), relating to limitation based on amount of tax, shall be reduced for the taxable year to—

(1) $25,000, multiplied by

(2) The qualified investment with respect to the total bases of new section 38 properties plus the qualified investment with respect to the total cost of used section 38 properties, apportioned to such estate or trust under paragraph (a) of this section, divided by

(3) The qualified investment with respect to the total bases of all new section 38 properties plus the qualified investment with respect to the total cost of all used section 38 properties, apportioned among such estate or trust and its beneficiaries.

For purposes of subparagraph (3) of this paragraph, cost of used section 38 property shall not be considered as apportioned to any beneficiary to the extent that such cost is not taken into account by such beneficiary in computing qualified investment in used section 38 property.

(d) *Summary statement.* An estate or trust shall attach to its return a statement showing the apportionment to such estate or trust and to each beneficiary of the total bases of new, and the total cost of used, section 38 properties within each useful life category.

(e) *Example.* This section may be illustrated by the following example:

Example. (1) XYZ Trust, which makes its return on the basis of the calendar year, ac-

quires and places in service on June 1, 1962, three new assets which qualify as new section 38 property and three used assets which qualify as used section 38 property. The basis of the new, and the cost of the used, section 38 property and the estimated useful life of each property are as follows:

Asset No.	Basis (or cost)	Estimated useful life
1 (new)	$30,000	4 years.
2 (new)	30,000	4 years.
3 (new)	30,000	8 years.
4 (used)	12,000	6 years.
5 (used)	12,000	6 years.
6 (used)	12,000	8 years.

For the taxable year 1962 the income of XYZ Trust is $20,000 which is allocable as follows: $10,000 to XYZ Trust, $6,000 to beneficiary A, and $4,000 to beneficiary B. Beneficiaries A and B make their returns on the basis of a calendar year.

(2) Under this section, the total bases of the new, and the total cost of the used, section 38 properties are apportioned to XYZ Trust and its beneficiaries as follows:

Useful life category	New—4 to 6 years	New—8 years or more	Used—6 to 8 years	Used—8 years or more
Total bases or total cost	$60,000	$30,000	$24,000	$12,000
XYZ Trust ($10,000 - 20,000)	30,000	15,000	12,000	6,000
Beneficiary A ($6,000 - 20,000)	18,000	9,000	7,200	3,600
Beneficiary B ($4,000 - 20,000)	12,000	6,000	4,800	2,400

Assume that beneficiary A placed in service during his taxable year 1962 new section 38 property with a basis of $10,000 and an estimated useful life of 8 years. Also, assume that beneficiary B did not place in service during his taxable year 1962 any section 38 property and that beneficiaries A and B did not own any interests in other trusts, estates, partnerships, or electing small business corporations. Under section 46(c), the qualified investment of XYZ Trust is $39,000, of beneficiary A is $33,400, and of beneficiary B is $15,600, computed as follows:

Basis (or cost)	Applicable percentage	Qualified investment
XYZ Trust		
$30,000 (new)	33⅓	$10,000
$15,000 (new)	100	15,000
$12,000 (used)	66⅔	8,000
$6,000 (used)	100	6,000
Total		39,000
Beneficiary A		
$18,000 (new)	33⅓	$6,000
$9,000 (new)	100	9,000
$7,200 (used)	66⅔	4,800
$3,600 (used)	100	3,600
		23,400
$10,000 (new)	100	10,000
Total		33,400
Beneficiary B		
$12,000 (new)	33⅓	$4,000
$6,000 (new)	100	6,000
$4,800 (used)	66⅔	3,200
$2,400 (used)	100	2,400
Total		15,600

(3) In the case of XYZ Trust, the $25,000 amount specified in section 46(a)(2) is reduced to $12,500, computed as follows: (i) $25,000, multiplied by (ii) $39,000 (qualified investment apportioned to the trust), divided by (iii) $78,000 (total qualified investment apportioned among such trust ($39,000), beneficiary A ($23,400), and beneficiary B ($15,600)).

[T.D. 6731, 29 FR 6083, May 8, 1964, as amended by T.D. 6931, 32 FR 14040, Oct. 10, 1967; T.D. 6958, 33 FR 9171, June 21, 1968; T.D. 7203, 37 FR 17133, Aug. 25, 1972]

§ 1.48-7 Adjustment to basis.

(a) *Reduction of basis; general*—(1) *In general.* Under section 48(g)(1), the basis of "section 38 property" placed in service before January 1, 1964, shall be reduced by an amount equal to 7 percent of the "qualified investment" with respect to such property. The reduction in basis shall be made as of

the time such property is placed in service by the taxpayer. The basis of such property must be reduced by 7 percent of the qualified investment even though the limitation based on amount of tax under section 46(a)(2) reduces the amount of the credit allowed by section 38 for the taxable year in which the property is placed in service. The reduction in basis of section 38 property placed in service before January 1, 1964, shall be taken into account for all purposes of subtitle A of the Code, except in computing (or recomputing in the case of early disposition, etc.) the qualified investment with respect to such property. Thus, such reduction in basis is taken into account in determining a reasonable allowance for depreciation under section 167, except that the additional amount allowed under section 179 (relating to additional first-year depreciation allowance for small business) with respect to the cost of certain property is determined without regard to such reduction in basis. Section 48(g)(1) and this section do not apply to section 38 property placed in service after December 31, 1963. For increase in basis of property to which this section applies, see paragraphs (c), (d), and (e) of this section.

(2) *Special rules.* For purposes of applying subparagraph (1) of this paragraph—

(i) If, under § 1.48-4, the lessor of new section 38 property makes a valid election to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, the basis of such property shall not be reduced.

(ii) If property is used section 38 property and if the cost, or any part thereof, of such property is not, because of the application of the $50,000 limitation on the cost of used section 38 property, taken into account in computing qualified investment (see paragraph (c) of § 1.48-3) by the person who placed such property in service or by a person to whom the cost of such property was apportioned, no reduction shall be made to the basis of such property to the extent such cost, or any part thereof, is not so taken into account.

(iii) In the case of used section 38 property within a particular useful life category the cost of which is apportioned by an electing small business corporation, estate, or trust, if any part of such cost is not taken into account in computing qualified investment (because of the $50,000 limitation) by a shareholder or beneficiary, the electing small business corporation, estate, or trust shall choose, to the extent such cost is not so taken into account, the item (or items) of used section 38 property, within such useful life category, with respect to which no reduction in basis shall be made.

(iv) The basis of section 38 property, which is disposed of or otherwise ceases to be section 38 property in the taxable year in which it is placed in service (except where § 1.47-3 applies), shall not be reduced. See paragraph (a)(2) of § 1.46-3.

(3) *Examples.* This paragraph may be illustrated by the following examples:

Example (1). (i) X Corporation, which makes its return on the basis of the calendar year, acquires and places in service on January 2, 1962, an item of new section 38 property with a basis of $10,000 and a useful life of 10 years. The amount of qualified investment with respect to such asset is $10,000 ($10,000 basis multiplied by 100 percent applicable percentage). For the taxable year 1962, X Corporation is allowed under section 38 a credit of $700 (7 percent of $10,000) against its liability for tax of $1,000.

(ii) Under section 48(g)(1), the basis of the property is reduced to $9,300 ($10,000 minus $700). Thus, for purposes of determining a reasonable allowance for depreciation under section 167 with respect to such property for the taxable year 1962, its adjusted basis is $9,300.

Example (2). (i) The facts are the same as in example (1) except that for the taxable year 1962 X Corporation's liability for tax under section 46(a)(3) is $500. Therefore, the credit allowed by section 38 against X Corporation's liability for tax for 1962 is limited to $500 and the excess of $200 ($700 credit earned minus $500 limitation) is an investment credit carryover.

(ii) The result is the same as in example (1), that is, under section 48(g)(1), the basis of the property is reduced to $9,300 ($10,000 minus $700).

Example (3). (i) The facts are the same as in example (1) except that the property is,

for purposes of depreciation, placed in a multiple asset account. On January 1, 1962, the cost or other basis of the property in such account amounted to $50,000 and no other additions or retirements were reflected in such account during 1962.

(ii) Under section 48(g)(1), since the basis of the property is reduced to $9,300 ($10,000 minus $700), the cost or other basis of the property in the multiple asset account is increased to $59,300 ($50,000 plus $9,300) for purposes of computing depreciation under section 167.

Example (4). (i) The facts are the same as in example (1) except that X Corporation makes a valid election under paragraph (a) of § 1.179-4 to claim an additional first-year depreciation allowance with respect to the entire cost of the property.

(ii) Under section 48(g)(1), the basis of the property is reduced to $9,300 ($10,000 minus $700). In addition, $2,000 (20 percent of $10,000) is allowed as an additional first-year depreciation allowance. Thus, for purposes of determining a reasonable allowance for depreciation under section 167 (in addition to the $2,000 computed under section 179) for the taxable year 1962 with respect to such property, its adjusted basis is $7,300 ($9,300 minus $2,000).

Example (5). (i) X Corporation acquires and places in service on January 1, 1962, used assets Nos. 1, 2, and 3. Each asset has a cost of $25,000 and a useful life of 10 years. Such used assets qualify as used section 38 property. X Corporation selects the $25,000 cost of used asset No. 1 and the $25,000 cost of used asset No. 2 to be taken into account in computing qualified investment.

(ii) Under section 48(g)(1), the basis of asset No. 1 is reduced to $23,250, that is, basis of $25,000 minus $1,750 (7 percent of $25,000 qualified investment). Likewise, the basis of asset No. 2 is reduced to $23,250. The basis of asset No. 3 is not reduced.

Example (6). (i) X Corporation acquires and places in service on January 1, 1962, used assets Nos. 1, 2, and 3 which qualify as used section 38 property. Each asset has a cost of $20,000 and a useful life of 10 years. X Corporation selects the $20,000 cost of used asset No. 1, the $20,000 cost of used asset No. 2, and $10,000 of the cost of used asset No. 3 to be taken into account in computing qualified investment.

(ii) Under section 48(g)(1), the basis of asset No. 1 is reduced to $18,600, that is basis of $20,000 minus $1,400 (7 percent of $20,000 qualified investment). Likewise, the basis of asset No. 2 is reduced to $18,600. The basis of asset No. 3 is reduced to $19,300, that is basis of $20,000 minus $700 (7 percent of $10,000 qualified investment).

Example (7). (i) X Corporation, an electing small business corporation which makes its return on the basis of the calendar year, acquires and places in service on January 1, 1962, five used assets which qualify as used section 38 property. The cost of each used section 38 property and the estimated useful life of each property are as follows:

Asset No.	Cost	Estimated useful life
1	$20,000	8 years
2	24,000	6 years
3	3,000	4 years
4	6,000	4 years
5	3,000	4 years

On December 31, 1962, X Corporation has 10 shares of stock outstanding which are owned as follows: A owns 3 shares, B owns 2 shares, and C owns 5 shares. All the shareholders make their returns on the basis of a calendar year. X Corporation selects the $20,000 cost of asset No. 1, the $24,000 cost of asset No. 2, the $3,000 cost of asset No. 3, and $3,000 of the cost of asset No. 4 to be apportioned to its shareholders. Under § 1.48-5, the total cost of the used section 38 property selected is apportioned to the shareholders of X Corporation as follows:

Useful life category	Used—4 to 6 years	Used—6 to 8 years	Used—8 years or more
Total cost	$6,000	$24,000	$20,000
Shareholder A (3/10)	1,800	7,200	6,000
Shareholder B (2/10)	1,200	4,800	4,000
Shareholder C (5/10)	3,000	12,000	10,000

Assume that shareholders A, B, and C did not place in service during their taxable years ending December 31, 1962, any section 38 property and that such shareholders did not own any interests in other electing small business corporations, partnerships, estates, or trusts. Under section 46(c)(1)(B) each shareholder computes his qualified investment as follows:

Cost	Applicable percentage	Qualified investment
SHAREHOLDER A		
$1,800	33 1/3	$600
$7,200	66 2/3	4,800
$6,000	100	6,000
		11,400
SHAREHOLDER B		
$1,200	33 1/3	$400
$4,800	66 2/3	3,200
$4,000	100	4,000
		7,600

Cost	Applicable percentage	Qualified investment
SHAREHOLDER C		
$3,000	33⅓	$1,000
$12,000	66⅔	8,000
$10,000	100	10,000
		19,000

(ii) Under section 48(g)(1), the basis of each asset (except asset No. 5) is reduced by 7 percent of the qualified investment with respect to such asset, as follows:

Asset No.	Basis before reduction	Qualified investment	Basis after reduction
1	$20,000	Minus 7% of $20,000	$18,600
2	24,000	Minus 7% of $16,000	22,880
3	3,000	Minus 7% of $1,000	2,930
4	6,000	Minus 7% of $1,000	5,930

The basis of asset No. 5 is not reduced.

Example (8). (i) The facts are the same as in example (7) except that shareholder C acquired and placed in service on June 1, 1962, in his individual proprietorship, used asset No. 6 with a cost of $27,000 and an estimated useful life of 10 years. In computing his qualified investment, shareholder C selects the $27,000 cost of asset No. 6, the $10,000 cost of used section 38 property within the 8 years or more useful life category apportioned to him by X Corporation, the $12,000 cost of used section 38 property within the 6 to 8 years useful life category apportioned to him by X Corporation, and $1,000 of the cost of used section 38 property within the 4 to 6 years useful life category apportioned to him by X Corporation. Under section 46(c)(1)(B), he computes his qualified investment as follows:

Proprietorship	Cost	Applicable percentage	Qualified investment
Asset No. 6	$27,000	100	$27,000
Apportioned by X corporation:			
8 years or more	10,000	100	10,000
6 to 8 years	12,000	66⅔	8,000
4 to 6 years	1,000	33⅓	333
			45,333

(ii) Since only $4000 of the $6000 cost of used section 38 property in the 4 to 6 years useful life category apportioned by X Corporation was taken into account by shareholders A, B, and C in computing their qualified investment, only $4000 of the bases of the assets in such category is subject to reduction. Under subparagraph (2)(iii) of this paragraph, X must choose an item of property in such category, $2000 of the basis of which will not be subject to the reduction. Therefore, X Corporation chooses to reduce the basis of asset No. 4 by 7 percent of qualified investment with respect to only $1,000 of the cost of such asset (in lieu of the $3,000 previously selected). The bases of assets Nos. 1, 2, and 3 are reduced by 7 percent of the qualified investment with respect to each such asset. The basis of each asset is reduced as follows:

Asset No.	Basis before reduction	Qualified investment	Basis after reduction
1	$20,000	Minus 7% of $20,000	$18,600
2	24,000	Minus 7% of $16,000	22,880
3	3,000	Minus 7% of $1,000	2,930
4	6,000	Minus 7% of $333	5,977

The basis of asset No. 5 is not reduced.

(iii) The basis of asset No. 6, in the hands of shareholder C, is reduced to $25,110, that is, basis of $27,000 minus $1,890 (7 percent of $27,000 qualified investment).

Example (9). (i) ABC Partnership, which makes its return on the basis of the calendar year, acquires and places in service on January 1, 1962, five used assets which qualify as used section 38 property. The cost of each used section 38 property and the estimated useful life of each property are as follows:

Asset No.	Cost	Estimated useful life
1	$20,000	8 years.
2	24,000	6 years.
3	3,000	4 years.
4	6,000	4 years.
5	3,000	4 years.

Partners A, B, and C share the profits and the losses of partnership ABC in the ratio of 50 percent, 30 percent, and 20 percent, respectively. ABC Partnership selects the $20,000 cost of asset No. 1, the $24,000 cost of asset No. 2, the $3,000 cost of asset No. 3, and $3,000 of the cost of asset No. 4, to be taken into account by its members in computing qualified investment. Under paragraph (f)(2) of § 1.46-3, each partner's share of the cost of the partnership used section 38 property to be taken into account in computing qualified investment is as follows:

Asset No.	Estimated useful life (years)	Cost	Partner's share of cost		
			A (50%)	B (30%)	C (20%)
1	8	$20,000	$10,000	$6,000	$4,000
2	6	24,000	12,000	7,200	4,800
3	4	3,000	1,500	900	600
4	4	3,000	1,500	900	600

Each partner makes his return on the basis of the calendar year. Assume that partners A, B, and C did not place in service during their taxable years ending December 31, 1962, any section 38 property and that such partners did not own any interests in other partnerships, estates, trusts, or electing small business corporations. Under section 46(c), each partner computes his qualified investment as follows:

Asset No.	Share of cost	Applicable percentage	Qualified investment
	PARTNER A		
1	$10,000	100	$10,000
2	12,000	66⅔	8,000
3	1,500	33⅓	500
4	1,500	33⅓	500
			19,000
	PARTNER B		
1	$6,000	100	$6,000
2	7,200	66⅔	4,800
3	900	33⅓	300
4	900	33⅓	300
			11,400
	PARTNER C		
1	$4,000	100	$4,000
2	4,800	66⅔	3,200
3	600	33⅓	200
4	600	33⅓	200
			7,600

(ii) Under section 48(g)(1), the basis of each asset selected by the partnership is reduced by 7 percent of the qualified investment with respect to such asset, as follows:

Asset No.	Basis before reduction	Qualified investment	Basis after reduction
1	$20,000	Minus 7% of $20,000	$18,600
2	24,000	Minus 7% of $16,000	22,880
3	3,000	Minus 7% of $1,000	2,930
4	6,000	Minus 7% of $1,000	5,930

The basis of asset No. 5 is not reduced.

Example (10). (i) The facts are the same as in example (9) except that partner A acquired and placed in service on June 1, 1962, in his individual proprietorship, used asset No. 6 with a cost of $26,000 and an estimated useful life of 10 years. Partner A selects the $26,000 cost of asset No. 6, his $10,000 share of the cost of asset No. 1, his $12,000 share of the cost of asset No. 2, his $1,500 share of the cost of asset No. 3, and $500 of his share of the cost of asset No. 4, to be taken into account in computing his qualified investment. Under section 46(c), he computes his qualified investment as follows:

Proprietorship property	Cost	Applicable percentage	Qualified investment
Asset No. 6	$26,000	100	$26,000
Partnership property	Share of cost		
Asset No. 1	$10,000	100	10,000
Asset No. 2	12,000	66⅔	8,000
Asset No. 3	1,500	33⅓	500
Asset No. 4	500	33⅓	167
			44,667

(ii) Under section 48(g)(1), the basis of each asset selected by the partnership is reduced by 7 percent of the qualified investment with respect to such asset as follows:

Asset No.	Basis before reduction	Qualified investment	Basis after reduction
1	$20,000	Minus 7% of $20,000	$18,600
2	24,000	Minus 7% of $16,000	22,880
3	3,000	Minus 7% of $1,000	2,930
4	6,000	Minus 7% of $667	5,953

The basis of asset No. 5 is not reduced.

(iii) The basis of asset No. 6, in the hands of partner A, is reduced to $24,180, that is, basis of $26,000 minus $1,820 (7 percent of $26,000 qualified investment).

(b) *Reduction of basis; purchase of leased property by lessee treated as purchaser.* (1) If a lessor of property placed in service before January 1, 1964, makes a valid election under § 1.48-4 to treat the lessee as having purchased such property for purposes of the credit allowed by section 38 and if such lessee at a later date (in a taxable year of the lessee beginning before January 1, 1964) actually purchases such property, the basis of such property shall be reduced, as of the

time of the actual purchase, by an amount equal to the excess of—

(i) The credit earned (as defined in paragraph (k)(2)(i) of § 1.48-4) with respect to such property, over

(ii) The sum of the amounts by which the lessee-purchaser has decreased, under paragraph (k)(2) of § 1.48-4, his deductions otherwise allowable under section 162 for amounts paid or accrued to the lessor-vendor under the lease with respect to such property.

(2) The operation of this paragraph may be illustrated by the following example:

Example. (i) X Corporation acquires on January 1, 1962, an item of new section 38 property with a basis of $12,000 and with a useful life of 8 years. Y Corporation, which makes its return on the basis of a calendar year, leases such property from X Corporation and places it in service on February 1, 1962. Under § 1.48-4, X Corporation makes a valid election to treat Y Corporation as having purchased such property for purposes of the credit allowed by section 38. Under paragraph (k)(2)(i) of § 1.48-4, the amount of the credit earned with respect to such property is $840 (7 percent of $12,000). For the taxable year 1962 Y Corporation decreases, under paragraph (k)(2)(ii) of § 1.48-4, its deductions otherwise allowable under section 162 for amounts paid to X Corporation under the lease with respect to such property by $96.25 ($840 multiplied by $^{11}/_{96}$). On January 1, 1963, Y Corporation actually purchases such property from X Corporation for $9,000.)

(ii) As of January 1, 1963, Y Corporation must reduce the basis of the property by $743.75 ($840 minus $96.25). Thus, for purposes of determining a reasonable allowance for depreciation under section 167 with respect to such property for the taxable year 1963, its adjusted basis is $8,256.25 ($9,000 minus $743.75).

(c) *Increase in basis on account of early disposition, etc.*—(1) *In general.* If, as a result of an early disposition, etc., in a taxable year beginning before January 1, 1964, with respect to section 38 property placed in service before such date, the tax imposed under chapter 1 of the Code is increased under section 47(a) (1) or (2), or an adjustment in an unused credit carryback or carryover is made under section 47(a)(3), then the basis of such property shall be increased. Such increase shall be in an amount equal to the sum of the portion of such increase in tax and the portion of such adjustment in carrybacks or carryovers attributable to such property but not in excess of the reduction in basis made under paragraph (a) of this section or, in the case of leased property purchased by a lessee treated as the purchaser, the reduction in basis under paragraph (b) of this section plus the decrease in rental deductions made under paragraph (k)(2) of § 1.48-4. See paragraph (a)(2) of this section for rules indicating when basis is not reduced under paragraph (a) of this section. The increase in basis of such property shall be made immediately before the event which causes section 47(a) (1), (2), or (3) to apply, and this increase in basis shall be taken into account for all purposes of subtitle A of the Code. If, after the event described in the preceding sentence, the taxpayer continues the use of the property in a trade or business or in the production of income, the principles described in paragraph (d)(1) of this section shall be applied in computing the allowances for depreciation over the remaining useful life of the property.

(2) *Examples.* The operation of this paragraph may be illustrated by the following examples:

Example (1). (a) The facts are the same as those in example (1) of paragraph (a)(3) of this section except that on June 15, 1963, corporation X sold the property causing section 47(a)(1) to apply.

(b) Section 48(g)(2) requires that the basis of said property be increased immediately before the sale by the amount of $700 which amount is equal to the increase in tax for the taxable year 1963 arising under section 47(a)(1) ($700 credit allowed less credit allowable of 0).

Example (2). (a) The facts are the same as in example (1) of this subparagraph except that for the taxable year 1962 X Corporation's liability for tax was only $500, and a $200 unused credit carryover to 1963 resulted.

(b) The result is the same as in example (1) of this subparagraph, that is, the basis of the property is increased under section 48(g)(2) by the amount of $700 ($500 credit allowed plus $200 adjustment in carryover to 1963 less credit allowable of 0).

Example (3). (a) The facts are the same as those in example (1) of paragraph (a)(3) of this section except that the property was physically located outside of the United States during more than 50 percent of the

taxable year 1963 within the meaning of paragraph (g) of § 1.48–1, and section 47(a)(1) therefore became applicable.

(b) The basis of the property is increased by $700 as of the first day of the taxable year 1963.

Example (4). (a) The facts are the same as example (5) of paragraph (a)(3) of this section. Assume also that on January 1, 1963, there is an early disposition, etc., of the three assets as described under section 47(a)(1).

(b) Section 48(g)(2) requires that the basis of asset No. 1 be increased immediately before such early disposition, etc., by the amount of $1,750 ($1,750 credit allowed less credit allowable of 0). Likewise, the basis of asset No. 2 is increased by the amount of $1,750. There is no increase in the basis of asset No. 3 since the basis of such asset was not reduced.

(d) *Increase in basis of property placed in service before January 1, 1964*—(1) *In general.* Under section 203(a)(2)(A) of the Revenue Act of 1964, the basis of section 38 property placed in service before January 1, 1964, shall be increased by an amount equal to 7 percent of the qualified investment with respect to such property (determined as of the date the property was placed in service) but not in excess of the net reduction in basis under section 48(g). For this purpose, the net reduction in basis under section 48(g) is the reduction in basis under section 48(g)(1) and paragraph (a) of this section less any increase in basis under section 48(g)(2) and paragraph (c) of this section. The increase in basis described in this paragraph shall be made as of the first day of the taxpayer's first taxable year beginning after December 31, 1963. For taxable years beginning after December 31, 1963, this increase in basis shall be taken into account for all purposes of subtitle A of the Code. Thus, for example, during that part of the remaining useful life of the property falling within the taxable years beginning after December 31, 1963, such increase in basis shall be taken into account in determining reasonable allowances for depreciation under section 167. In determining depreciation allowances with respect to the property for periods after such increase in basis, appropriate adjustments shall be made (except as otherwise provided in this paragraph), whenever necessary, to the rate or other factors previously applied for taxable years beginning before January 1, 1964, so that the total depreciation allowances made during the remaining useful life of the property, plus the allowances for the expired useful life, will equal or approximate the allowances which would have resulted if section 48(g)(1) had not applied. In the case of section 38 property contained in a multiple asset account, the taxpayer may reflect the increase in basis by adjusting the basis of the account and by adjusting the rate of depreciation applied to the entire account. In lieu of that, he may continue to apply to the entire account (reflecting the basis increase) the rate previously employed. As a third alternative, solely for the purposes of determining the depreciation adjustment occasioned by the increase in basis (and not for the purposes of determining method of depreciation, effect of retirements, application of sections 1245 and 1250, or other purposes), he may continue to utilize the previous rate for the main account (not reflecting the increase in basis) and treat the increase in basis as a separate account to be depreciated over the remaining useful life of the assets to which the increase in basis relates. Except as provided in section 167 and the regulations thereunder, no change may be made in the method of depreciation to be applied during the remaining life of the property. For purposes of section 167(d), any increase in basis under this paragraph shall constitute a fact not taken into consideration in the adoption of any agreement under that section fixing the rate of depreciation. In no event shall an adjustment be made which would result in recovery of the increase in basis through depreciation allowances prior to expiration of the remaining useful life.

(2) *Special rules.* (i) The increase in basis provided by subparagraph (1) of this paragraph shall be taken into account ordinarily by the person in whose hands the basis of the property was reduced under section 48(g)(1). However, if the property is transferred in a transaction described in section 47(b) (other than a transfer by reason of death) prior to the first day of the

first taxable year of the transferor beginning after December 31, 1963, then, to the extent that the basis of such property reflects the net reduction in basis described in subparagraph (1) of this paragraph in the hands of the transferor, the increase in basis provided for in this paragraph shall be taken into account by the transferee.

(ii) The basis of any section 38 property is not to be increased under subparagraph (1) of this paragraph if the taxpayer dies in a taxable year beginning before January 1, 1964.

(3) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example (1). (a) A, an individual who makes his return on the basis of the calendar year, acquired and placed in service on January 1, 1962, asset No. 1 and asset No. 2, both of which assets qualified as new section 38 property. Each asset had a basis of $10,000, a salvage value of $1,000, and an estimated useful life of 10 years. Depreciation for each asset was computed under the straight line method. For the taxable year 1962, A was allowed under section 38 a credit of $1,400 (7 percent of $20,000). On January 2, 1963, A took asset No. 1 out of his business and on said date commenced to use such property entirely for personal purposes. Thus, for purposes of section 48(g)(2), there was an early disposition, etc., as described under section 47(a)(1).

(b) Under section 48(g)(1), the basis of each asset in 1962 was reduced to $9,300. Thus, depreciation with respect to each asset for the taxable year 1962 was $830 (adjusted basis of $9,300 minus salvage value of $1,000 divided by estimated useful life of 10 years).

(c) Immediately before the early disposition, etc., with respect to asset No. 1, the basis of such asset was increased by $700 to $9,170 (cost of $10,000 minus reduction in 1962 under section 48(g)(1) of $700, minus depreciation of $830, and plus the addition to basis in 1963 under section 48(g)(2) of $700). As of December 31, 1963, the adjusted basis of asset No. 2 was $7,640 (original cost of $10,000 minus reduction in 1962 under section 48(g)(1) of $700, minus depreciation of $830 in 1962, and minus depreciation of $830 in 1963).

(d) The basis of asset No. 1 is not increased under this section since the basis of such asset had previously been increased under section 48(g)(2) in the amount of $700, the full amount of the reduction previously made under section 48(g)(1). The basis of asset No. 2 is increased under this paragraph as of January 1, 1964, by $700 to $8,340 ($7,640 plus 7 percent of $10,000). The rate of depreciation to be applied to the adjusted basis of asset No. 2 for the remaining useful life of 8 years is adjusted in order to produce a total depreciation allowance of $9,000 at the end of the asset's useful life. Depreciation with respect to such asset for the taxable year 1964 and for each of the succeeding 7 years is $917.50 (adjusted basis of $8,340 minus salvage value of $1,000 divided by estimated remaining useful life of 8 years).

Example (2). (a) X Corporation, which makes its return on the basis of the calendar year, acquired and placed in service on January 1, 1962, an asset which qualified as new section 38 property. The asset had a basis of $165,000, a salvage value of $15,000, and an estimated useful life of 5 years. Depreciation was computed under the declining balance method at a rate of 200 percent of the straight line rate. The qualified investment with respect to such asset was $55,000 (33⅓ percent of $165,000). For the taxable year 1962, X Corporation was allowed under section 38 a credit of $3,850 (7 percent of $55,000).

(b) Under section 48(g)(1), the basis of such property in 1962 was reduced to $161,150 ($165,000 minus $3,850). Thus, depreciation with respect to such asset for the taxable year 1962 was $64,460 (adjusted basis of $161,150 multiplied by 40 percent). Depreciation for the taxable year 1963 was $38,676 ($161,150 minus $64,460 multiplied by 40 percent).

(c) As of January 1, 1964, the basis of such property is increased by $3,850 to $61,864 ($161,150 minus $64,460, minus $38,676, and plus $3,850). No adjustment in the rate of the allowance for depreciation is necessitated by the increase in basis under this section since the rate and method applied in 1962 and 1963 will produce a total allowance of $150,000 over the entire estimated useful life of the property. Thus, depreciation with respect to such asset for 1964 is $24,746 ($61,864 multiplied by 40 percent), for 1965 is $14,847 ($61,864 minus $24,746 multiplied by 40 percent), and for 1966 is $7,271, since such property cannot be depreciated below its salvage value of $15,000.

Example (3). (a) The facts are the same as in example (2) except that depreciation was computed under the sum of the years-digits method. Thus, depreciation with respect to such asset for the taxable year 1962 was $48,717 (adjusted basis of $161,150 minus $15,000 multiplied by 5/15). For the taxable year 1963 depreciation was $38,973 ($161,150 minus $15,000 multiplied by 4/15).

(b) As of January 1, 1964, the basis of such property is increased in the amount of $3,850. In order to produce a total allowance of $150,000 over the entire useful life, it is necessary to adjust the annual allowance. Thus, as of January 1, 1964, under the tax-

payer's method of depreciation, a new rate of 3/8 is determined for the taxable year 1964. Commencing with such taxable year, this new rate is applied against the asset's adjusted basis of $77,310 minus salvage value of $15,000. The adjusted basis as of January 1, 1964, is determined as follows:

Original cost to taxpayer		$165,000
Less: Reduction for investment credit as prescribed by paragraph (a)	$3,850	
Depreciation for 1962	48,717	
Depreciation for 1963	38,973	91,540
		73,460
Add: Increase prescribed by this paragraph		3,850
Adjusted basis as of January 1, 1964		77,310

Depreciation for the taxable year 1964 is $31,155 (adjusted basis of $77,310 minus salvage value of $15,000 multiplied by 3/8). Likewise, depreciation for the taxable year 1965 shall be $20,770 ($77,310 minus $15,000 multiplied by 2/8).

Example (4). (a) The facts are the same as in example (2) except that the useful life was estimated in terms of units of production and depreciation was computed under the unit-of-production method. The estimated total production of the property was 150,000 units, and 30,000 units were produced annually. Thus, depreciation for the taxable year 1962 was $29,230 (adjusted basis of $161,150 minus $15,000 multiplied by 30,000/150,000). For the taxable year 1963 depreciation was again $29,230.

(b) As of January 1, 1964, the basis of such property is increased in the amount of $3,850. In order to permit a total allowance of $150,000 over the entire useful life of the property, it is necessary to adjust the annual allowance for depreciation over its remaining life. Thus, as of January 1, 1964, under the taxpayer's method of depreciation, a new rate of 30,000/90,000 is determined for the taxable year 1964. Commencing with such taxable year, this new rate is applied against the adjusted basis of the property of $106,540 minus salvage value of $15,000. The adjusted basis as of January 1, 1964, is determined as follows:

Original cost to taxpayer		$165,000
Less: Reduction for investment credit as prescribed by paragraph (a)	$3,850	
Depreciation for 1962	29,230	
Depreciation for 1963	29,230	62,310
		102,690
Add: Increase prescribed by this paragraph		3,850
Adjusted basis as of January 1, 1964		106,540

Depreciation for the taxable year 1964 is $30,513 (adjusted basis of $106,540 minus salvage value of $15,000 multiplied by 30,000/90,000). Likewise, for the taxable year 1965 depreciation shall be $30,513 ($106,540 minus $15,000 multiplied by 30,000/90,000).

Example (5). (a) X Corporation, a calendar year basis taxpayer, acquired and placed in service on January 1, 1962, a number of assets which qualified as new section 38 property. Such assets had a total basis of $180,000, a total salvage value of $18,000 and were accounted for in a multiple asset account containing other assets similar in kind, but not qualifying as section 38 property. Depreciation was computed under the straight line method over an average estimated useful life of 10 years.

For the taxable year 1962, X Corporation was allowed under section 38 a credit of $12,600 (7 percent of $180,000). Under section 48(g)(1), the basis of such property in 1962 was reduced to $137,400.

(b) As of January 1, 1964, the basis of the assets is increased in the amount of $12,600. To produce a total allowance equal to the allowance which would have resulted if section 48(g)(1) had not applied, an adjustment in the rate of depreciation would be necessary. If the taxpayer selects the third alternative described for multiple asset accounts in subparagraph (1) of this paragraph, the amount of the adjustment will be determined with reference to the increase in basis alone. In that case, under the taxpayer's method of depreciation, depreciation with respect to the increase in basis for the taxable year 1964 and for each of the seven succeeding years is $1,575 (increase in basis of $12,600 divided by estimated remaining useful life of 8 years).

(e) *Increase in basis; purchase of leased property by lessee treated as purchaser*—(1) *In general.* If a lessor of property placed in service before January 1, 1964, made a valid election under § 1.48–4 to treat the lessee as having purchased such property for purposes of the credit allowed by section 38 and if the lessee actually purchased the property at a later date prior to the expiration of the useful life used in computing the credit, the basis of the property shall be increased. If the property was purchased by the lessee in a taxable year beginning before January 1, 1964, the increase shall be made as of the first day of the lessee's first taxable year beginning after December 31, 1963, in an amount equal to 7 percent of the qualified investment in the property (determined as of the date the property was placed in service), but not in

excess of the reduction in basis made under paragraph (b) of this section plus the decrease in rental deductions made under paragraph (k)(2) of § 1.48-4. If the property was purchased by the lessee in a taxable year beginning after December 31, 1963, the increase shall be made to the basis of the property as of the date of purchase by an amount equal to any decrease in rental deductions actually made under paragraph (k)(2) of § 1.48-4 minus any increase in rental deductions taken into account by the lessee under paragraph (m) of § 1.48-4. Any increase in basis under this paragraph shall be reduced to the extent of any increase in basis previously made under paragraph (c) of this section on account of early disposition, etc., of the property. For taxable years of a lessee beginning after December 31, 1963, such increase in basis shall be taken into account for all purposes of subtitle A of the Code.

(2) *Special rules.* (i) The increase in basis provided by this paragraph shall be taken into account ordinarily by the lessee treated as the purchaser. However, if the property under the lease is transferred before the purchase by the lessee to a successor lessee in a transaction described in section 47(b) (other than a transfer by reason of death) under which the successor lessee assumes the lessee's obligations under the lease, or if the property is purchased by the lessee in a taxable year beginning before January 1, 1964, and subsequently transferred in a transaction described in section 47(b) (other than a transfer by reason of death), the increase in basis provided for in this paragraph shall be taken into account by the transferee.

(ii) The basis of any section 38 property is not to be increased under subparagraph (1) of this paragraph if the taxpayer dies in a taxable year beginning before January 1, 1964.

(3) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example (1). (a) X Corporation acquired on January 1, 1962, an item of new section 38 property with a basis of $10,000, an estimated useful life of 10 years, and a salvage value of $1,000. Y Corporation, which makes its return on the basis of a calendar year, leased such property from X Corporation and placed it in service on January 2, 1962. Under § 1.48-4, X Corporation made a valid election to treat Y Corporation as having purchased such property for purposes of the credit allowed by section 38. The amount of the credit earned with respect to such property was $700 (7 percent of $10,000). For the taxable year 1962, Y Corporation decreased, under paragraph (k)(2) of § 1.48-4, its deductions otherwise allowable under section 162 for amounts paid to X Corporation under the lease with respect to such property by $70 ($700 multiplied by $^{12}/_{120}$). On January 1, 1963, Y Corporation purchased such property from X Corporation for $8,830.

(b) As of January 1, 1963, Y Corporation in accordance with paragraph (b) of this section reduced the basis of the property by the amount of $630 ($700 minus $70). The adjusted basis of the property for the taxable year 1963 for purposes of determining a reasonable allowance for depreciation under section 167 was $8,200 ($8,830 minus $630). Depreciation under the straight line method for such taxable year amounted to $800 (adjusted basis of $8,200 minus salvage value of $1,000 and divided by estimated remaining useful life of 9 years). As of December 31, 1963, the adjusted basis had been reduced to $7,400 ($8,200 minus depreciation of $800 for the taxable year 1963).

(c) As of January 1, 1964, the basis of such property is increased to $8,100 ($7,400 plus $700). To permit a total allowance of $7,900 over the entire useful life of the property (treating as a part of the depreciable basis of the property the decrease of $70 made in the taxpayer's rental deductions for the taxable year 1962), it is necessary to recompute the annual allowance for depreciation. Thus, depreciation for the taxable year 1964 and for each of the 7 succeeding years is $887.50 (adjusted basis of $8,100 minus salvage value of $1,000 and divided by estimated remaining useful life of 8 years).

Example (2). (a) The facts are the same as in example (1) of paragraph (m)(2) of § 1.48-4 except that Y Corporation purchased the property on January 3, 1965, for $20,000.

(b) For the taxable year 1964 Y Corporation increases its deductions otherwise allowable under section 162 by $42.

(c) As of January 3, 1965, Y Corporation increases the basis of the property ($20,000) by $294 ($336 decrease in rental deductions made in 1962 and 1963 minus $42 increased rental deductions taken into account in 1964).

[T.D. 6731, 29 FR 6084, May 8, 1964, as amended by T.D. 6838, 30 FR 9061, July 20, 1965; T.D. 6931, 32 FR 14040, Oct. 10, 1967]

§ 1.48-8 Motion picture and television films and tapes.

(a) *Entitlement to investment credit*—(1) *In general.* Under section 48(k) an investment credit is allowable under section 38 with respect to certain motion picture films and video tapes. For the taxpayer to be entitled to the investment credit, the film or tape placed in service must be "new section 38 property", determined without regard to its useful life. The film or tape must be a qualified film within the meaning of paragraph (a)(3) of this section, and the taxpayer must have an ownership interest in at least a part of the film (within the meaning of paragraph (a)(4) of this section). The investment credit is allowable only for the year in which the qualified film is placed in service except for investment credit with respect to subsequently incurred costs described in paragraph (e)(9) of this section. The refund (or credit) of any overpayment of tax that is attributable to the investment credit is subject to the provisions of section 6511. The provisions of this paragraph apply to all films and tapes regardless of the taxable year in which the film or tape was placed in service.

(2) *Film may be divided into parts.* Once a qualified film is placed in service in any medium of exhibition in any geographical area of the world, it becomes used property and no investment credit with respect to the film is available to a taxpayer that acquires the film after that time (except for subsequently incurred costs described in paragraph (e)(9) of this section which the taxpayer incurs). Thus, for example, a film previously exhibited in theaters will not be new section 38 property even when modified for television. However, where parts of film have been sold before the film or any of its parts have been placed in service in any medium of exhibition in any geographical area of the world, each part is new section 38 property until that part is first placed in service. For purposes of this section, "a part" of a film means the exclusive right to display a qualified film in one or more mediums of exhibition in one or more geographical areas over the entire period of substantial exploitation of the film in the medium(s) in the geographical area(s). The period will be determined on the basis of a reasonable estimate made as of the date the film is first placed in service. For purposes of this section the term "medium of exhibition" includes, for example, free television (network telecasts and television syndications) or movie theaters. The term does not include the video tape or video disc household markets. For purposes of this section, the term "geographical area" means a geographically defined commercial market recognized by the movie or television industry, but which in no case may be smaller than one country or include a portion of a country. Notwithstanding the preceding sentence, border areas of Canada and Mexico, which under industry practice are considered part of the United States television market, may be treated as within the geographical area that includes the United States and not within the geographical area that includes Canada or Mexico. (See paragraph (g)(1) of this section for apportionment of amount paid if a taxpayer purchases one or more parts of a film and in the same transaction acquires an interest which does not constitute a part.) If the owner of a qualified film transfers to another person rights to display the film on a limited basis, which do not constitute a transfer of an ownership interest in a part of the film, the owner will still be treated as having "the exclusive right to display the film." For example, if the owner of a film transfers to a television network the right to display the film on network television (but does not transfer to the network syndication rights) the owner is considered to retain the "exclusive right to display the film." On the other hand, if the owner transfers to a television network all free television rights (network telecasts and television syndications) to the film before the film or any of its parts have been placed in service, the owner is considered to have sold a part of the film to the network and the network will be entitled to claim investment credit based on its qualified United States production costs as determined under paragraph (g)(1) of this section.

(3) *Qualified film*—(i) *In general.* Under section 48(k)(1)(B), the term "qualified film" means a motion picture film or video tape or part thereof created primarily for use as public entertainment or for educational purposes. A film or tape is a single asset consisting of the physical films and tapes (including the original negative or tape and duplicate negatives, release prints or tapes, and original sound recordings and all other sound recordings, if any, created to simultaneously accompany the pictorial material), and the worldwide rights to exploit the completed film or tape in all mediums of exhibition in all geographical areas of the world.

(ii) *Public entertainment or educational purposes.* A film or tape is created primarily for use as public entertainment only if created principally for public exhibition for the amusement, enlightenment, or gratification of an audience. Thus, a dramatic or situation comedy show or episode of a dramatic or situation comedy series would be a film or tape created primarily for use as public entertainment. A film or tape is created primarily for educational purposes if it is created principally for use by educational institutions or governmental units such as primary or secondary schools, colleges and universities, vocational and post-secondary educational institutions, public libraries, and other government agencies. Films and tapes created primarily for use by industrial or commercial organizations do not qualify for the credit. Thus, advertisements and industrial training films and tapes do not qualify for the credit.

(iii) *Topical or transitory films and tapes.* The term "qualified film" does not include any film or tape the market for which is primarily topical or is otherwise essentially transitory in nature. A film or tape is topical or essentially transitory in nature if it primarily deals with events and personalities of current interest at the time the film or tape is placed in service. It does not matter that a film or tape which is topical or essentially transitory in nature may be shown in subsequent years or is actually shown in subsequent years. These films or tapes include news shows such as the evening news and news specials relating to current affairs, interview shows such as "The Tonight Show" or "Meet the Press", game shows, award shows, and shows consisting of sporting events. Similarly, variety shows do not qualify for the credit since they present entertainers primarily as personalities of current interest, as opposed to dramatic or situation comedy shows which present entertainers as characters in a dramatization. Topical or transitory films and tapes do not include, however, dramatized recreations of recent events.

(4) *Ownership interest*—(i) *In general.* To obtain the investment credit with respect to a qualified film, a taxpayer must have an ownership interest in at least a part of the film. That is, the taxpayer must have a depreciable interest in at least a part of the film. However, the amount of credit allowable to a taxpayer with respect to a qualified film is determined only on the basis of that taxpayer's proportionate share of any loss which may be incurred with respect to the production costs of the qualified film. The proportionate share of any loss which may be incurred with respect to production costs by a taxpayer is the amount that the taxpayer's capital is at risk. Advance rentals (i.e., payments for the transfer of less than a part) received or accrued by a taxpayer prior to the date on which a qualified film is placed in service, and which are includible as ordinary income in the taxpayer's gross income will not reduce the amount that the taxpayer's capital is at risk. If a taxpayer's capital is considered at risk under the principles of section 465, the taxpayer's capital will be considered to be at risk under this paragraph. Regardless of whether a taxpayer is at risk under the principles of section 465, a taxpayer's capital will be considered at risk under this paragraph if the taxpayer will suffer the economic loss if the qualified film fails to generate sufficient revenue to cover or repay production costs. For purposes of this paragraph, the amount which a taxpayer has at risk will not be considered to be reduced by a deduction for participations or residuals paid or accrued, or by a deduction under section 167 with respect to the

costs of preparing prints described in paragraph (f)(1)(ii) of this section.

(ii) *Time ownership interest is determined.* An ownership interest in a qualified film and the amount that the taxpayer's capital is at risk with respect to the interest is determined at the time the film is placed in service. However, an ownership interest with respect to subsequently incurred costs (described in paragraph (e)(9) of this section) and the amount at risk with respect to such costs are determined at the time they are paid or incurred. Thus, a taxpayer purchasing a part of a qualified film after the film has been placed in service acquires no ownership interest in that part for purposes of the credit except with respect to subsequently incurred costs. However, if a taxpayer had purchased the part before the film has been placed in service in any medium of exhibition in any geographical area of the world, the taxpayer will have acquired an ownership interest in that part of the film for purposes of the credit.

(iii) *Certain lenders and guarantors considered to have an ownership interest.* To qualify for the investment credit with respect to a qualified film, the taxpayer must have a depreciable interest in at least a part of the film. Solely for purposes of this paragraph, a taxpayer who, at the time a film is first placed in service, is a lender or guarantor of all or a portion of the funds used to produce or acquire the film or part thereof, will be regarded as having a depreciable interest in at least a part of the film if he can look for repayment or relief from liability solely to the proceeds generated from the exhibition or disposition of at least a part of the film. In addition, if the financing for a film was part of an agreement which provided funds for the production of several qualified films, and a lender or guarantor can look for repayment or relief from liability solely to the aggregate proceeds generated from at least a part of each film, the lender or guarantor will be considered to have an ownership interest in each film. A commercial lender will not be considered to have an ownership interest in any film simply by reason of a commercial loan. If a lender or guarantor (other than a producer who owned the film and made or guaranteed a loan to a purchaser) is regarded as having an ownership interest in the film, the lender or guarantor shall be treated as having purchased the interest under paragraph (g)(1) of this section for an amount equal to the principal amount of the loan which it made or guaranteed.

(iv) *Partnerships, electing small business corporations, and estates and trusts.* If a partnership has an ownership interest in a qualified film, the qualified investment will be apportioned pro rata among the partners on the basis of their percentage of capital at risk in the partnership at the time the film is placed in service. If an electing small business corporation has an ownership interest in a qualified film, the qualified investment will be apportioned among the shareholders on the basis of their percentage of ownership of stock of the corporation on the last day of its taxable year in which the film is placed in service. If an estate or trust has an ownership interest in a qualified film, the qualified investment will be apportioned between the estate or trust and the beneficiaries on the basis of the distributable net income of the estate or trust allocable to each in the taxable year of the trust or estate in which the film is placed in service. For purposes of determining ownership interest with respect to subsequently incurred costs (described in paragraph (e)(9) of this section), a taxpayer's proportionate share of the capital at risk in a qualified film owned by a partnership or electing small business corporation is determined on the basis of the taxpayer's capital at risk in the entity on the last day of the taxable year of the entity in which the subsequently incurred costs are paid or incurred. The amount of capital which a taxpayer has at risk does not include any amount previously taken into account in determining the investment credit to which the taxpayer is entitled under section 48(k). For example, if a taxpayer has claimed investment credit with respect to the entire amount which he has at risk in a partnership, no additional investment credit may be claimed by the taxpayer with respect to that amount. However,

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if a taxpayer's capital at risk that was invested in a qualified film is recovered and re-invested in another qualified film, investment credit with respect to the amount reinvested may be claimed.

(v) *Examples.* This subparagraph may be illustrated by the following examples:

Example (1). (a) Partnership P executes a production-distribution agreement with D, a motion picture distribution company, for P to produce a new feature-length motion picture. D agrees to provide the funds for the production by direct loans to P. The amounts borrowed by P would be repayable only out of net profits from the distribution of the picture. P assumes no liability for the repayment of any amount. In consideration for the sum advanced by D, P assigns to D the sole and exclusive right to rent, lease, exhibit, license and otherwise dispose of, or trade and deal in and with the picture. Proceeds realized from the sale or distribution of the picture would first be used to reimburse D for amounts advanced. Any amount remaining following the reimbursement to D would be distributed 50 percent to D and 50 percent to P. For purposes of this example, it is assumed that neither a partnership nor a joint venture is created.

(b) Under paragraph (a)(4)(iii) of this section, D is regarded as having a depreciable interest in the picture for purposes of the credit. P's only interest in the picture is to share in any future profits. Since only D's capital is at risk, D may claim the allowable credit with respect to the entire qualified U.S. production costs of the picture.

Example (2). (a) A and B execute a partnership agreement under which B agrees to provide the funds for the production of a motion picture in return for a 50-percent interest in the net profits of the film. A agrees to provide his services and to supply the necessary talent to produce the film in exchange for the remaining 50-percent interest. Any lease, exhibition, license, or other disposition of the film is subject to the veto of either party.

(b) The AB partnership has a depreciable interest in the film. Under paragraph (a)(4)(iv) of this section, the qualified investment will be apportioned among the partners on the basis of their percentage of capital at risk in the partnership. A has no capital at risk in the partnership and therefore is not entitled to any credit with respect to the film. Since B has supplied all the risk capital for the partnership, B may claim all the investment credit with respect to the film.

Example (3). (a) X produces a new feature-length motion picture with its own funds. Upon completion X sells the film to Y. The purchase price is payable solely out of the proceeds generated from the exhibition of the film in movie theaters in the United States. Y obtains exclusive control over the distribution of the film and agrees to use its best efforts in promoting the distribution.

(b) Since X can look solely to the proceeds generated from the exhibition of the film to recoup its funds used to produce the film, X is treated as having a depreciable interest for purposes of the credit. Since X's capital at risk equals the production costs of the film, X may claim all of the investment credit with respect to the film.

(c) The facts are the same as in (a) of this example except that as part of the purchase agreement Y paid to X $200,000 on the delivery of the film which could be recouped by Y before any further amount was paid to X. At the time the film is placed in service both X and Y have an ownership interest in the film. Y has $200,000 of its capital at risk and is entitled to investment credit to the extent that the amount does not exceed the qualified United States production costs (as defined in paragraph (e)(1) of this section) of the film. X is entitled to the credit with respect to the remainder, if any, of the qualified United States production costs.

Example (4). (a) T, a television network, produces an in-house film for television. Prior to the time the film is placed in service, T transfers to S the rights to syndicate the film among nonaffiliated stations within the United States, beginning two years after the film is first shown on network television. In exchange for the syndication rights, S pays T an amount equal to 25 percent of the total production costs of the film.

(b) Under paragraph (a)(2) of this section, if the owner of a qualified film transfers to another taxpayer rights to display a film on a limited basis, which do not constitute a transfer of an ownership interest in a part of the film, the owner will still be treated as having the exclusive right to display the film. The transfer of only syndication rights to S is a transfer of less than a part of the film. Accordingly, T is treated as retaining the exclusive right to display the film and is entitled to the entire investment credit.

Example (5). (a) Individuals C and D form a partnership and each makes a capital contribution of $50,000. The partnership produces a qualified film which has qualified United States production costs of $100,000 and places it in service. On the partnership return for the taxable year, gross receipts from the film are $120,000, a depreciation deduction of $90,000 is allowed, and $50,000 of other expenses relating to the film are properly deducted. The partnership uses the $70,000 remaining after the loss on the film to produce a second qualified film en-

tirely in the United States which is also placed in service.

(b) C and D may each claim investment credit with respect to $50,000 of the qualified investment relating to the first qualified film produced by the partnership. In addition, under paragraph (a)(4)(iv) of this section, if a taxpayer's capital at risk that was invested in a qualified film is recovered and reinvested in another qualified film, investment credit with respect to the amount reinvested may be claimed. Accordingly, each partner may also claim an additional investment credit with respect to $35,000 of the qualified investment relating to the second qualified film.

(5) *Placed in service.* A qualified film is placed in service when it is first exhibited or otherwise utilized before the primary audience for which the qualified film was created. Thus, a qualified film is placed in service when it is first publicly exhibited for entertainment purposes and a qualified educational film is placed in service when it is first exhibited for instructional purposes. Each episode of a television film or tape series is placed in service when it is first exhibited. A qualified film is not placed in service merely because it is completed and therefore in a condition or state of readiness and availability for exhibition, or merely because it is exhibited to prospective exhibitors, sponsors, or purchasers, or is shown in a "sneak preview" before a select audience.

(b) *Applicable percentage for post-1974 qualified films.* For all qualified films placed in service in taxable years beginning after December 31, 1974, the applicable percentage under section 46(c)(2), which is used to determine the qualified investment, is 66⅔ percent unless the taxpayer elects to have the credit computed under the 90 percent rule provided in section 48(k)(3). If the taxpayer determines the credit under section 48(k)(2) (using an applicable percentage of 66⅔ percent), section 47 (relating to recapture of investment credit upon early disposition) will not apply with respect to investment credit claimed on a qualified film.

(c) *Election of 90-percent rule*—(1) *In general.* If a taxpayer makes an election under section 48(k)(3), the applicable percentage under section 46(c)(2) for each qualified film will be determined on a film-by-film basis. The taxpayer must state an estimated useful life for each qualified film and any investment credit claimed is subject to recapture upon early disposition or upon early expiration of its useful life. For purposes of this paragraph, a qualified film's useful life will be considered to have expired at the close of the first taxable year in which the aggregate amount allowable as a deduction under section 167 equals or exceeds 90 percent of the basis of the film. If the taxpayer determines the deduction under section 167 using a method which does not require an estimate of the useful life of the film in terms of years (*e.g.*, the income forecast method), the estimated total income or other estimate used in computing the deduction for the taxable year in which a qualified film is placed in service must be used for all subsequent years in determining whether the aggregate amount allowable as a deduction under section 167 equals or exceeds 90 percent of the basis of the film. In determining whether the aggregate amount allowable as a deduction under section 167 equals or exceeds 90 percent of the basis of the film, contingent costs determined after a film is placed in service are not taken into account.

(2) *Time and manner for making the election.* To elect under section 48(k)(3) to use the 90-percent rule in determining investment credit with respect to qualified films placed in service in taxable years beginning after December 31, 1974, the taxpayer shall write in parentheses, "48(k)(3)" after the cost or basis of property upon which the credit is claimed on the Form 3468 filed with the original return for the taxable year for which the 90-percent rule will first apply. The election may not be made on an amended return filed after the time prescribed for filing the original return (including extensions) for that taxable year. Notwithstanding the preceding sentences, an election with respect to taxable years ending before April 5, 1979, will be valid if the taxpayer indicates on an amended return or returns filed with the district director having audit jurisdiction over the last return to which the election relates on or before July 5, 1979, that

the taxpayer wishes section 48(k)(3) to apply. A taxpayer that has claimed investment credit for any preceding taxable year with respect to any qualified film placed in service in a taxable year beginning after December 31, 1974, using the applicable percentage determined under section 48(k)(2), may not elect to use section 48(k)(3) unless the consent of the Secretary has been obtained.

(3) *Who may elect.* The election under section 48(k)(3) may be made by any taxpayer that has a depreciable interest in a qualified film. However, where a qualified film is owned by a partnership, electing small business corporation (as defined in section 1371(b)), estate, or trust, the election must be made separately by each partner, shareholder or beneficiary. The election is not to be made by a partnership or electing small business corporation and is to be made by a trust or estate only if the trust or estate in determining its tax liability would be allowed investment credit on a qualified film subject to the election. The election of any partner, shareholder, beneficiary or trust or estate will be effective regardless of whether any related partner, shareholder, beneficiary, or trust or estate makes the election. The method used by the taxpayer or any related business entity for the first taxable year for which investment credit under section 48(k) (2) or (3) was claimed must be used for all subsequent years. A different method may be used by the taxpayer or any related business entity for subsequent years only if permission is first obtained from the Secretary.

(4) *Related business entity.* Two or more corporations, partnerships, trusts, estates, proprietorships, or other entities are "related business entities" if the conditions described in section 48(k)(3)(D) are met.

(d) *Predominant use test and qualified investment*—(1) *Place of exhibition not relevant.* For qualified films placed in service in taxable years beginning after December 31, 1974, section 48(a)(2) (relating to property used outside the United States) does not apply. Whether a qualified film is ultimately exhibited entirely within the United States, entirely outside the United States, or partially within and partially outside the United States, is not relevant for purposes of determining the investment credit.

(2) *Qualified investment.* In determining the qualified investment under section 46(c)(1), in place of the basis of a qualified film an amount equal to the qualified United States production costs (as defined in section 48(k)(5) and paragraph (e)(1) of this section) with respect to the film must be used.

(e) *Definitions*—(1) *Qualified United States production costs.* For purposes of section 48(k), the term "qualified United States production costs" means with respect to any film—

(i) Direct production costs allocable to the United States, plus

(ii) If 80 percent or more of the direct production costs are allocable to the United States, all other production costs except direct production costs allocable outside the United States.

(2) *Production costs.* The term "production costs", for purposes of section 48(k), includes the following:

(i) A reasonable allocation of general overhead costs, if capitalized,

(ii) The cost of obtaining screen rights and other material being filmed, and of developing the screenplay, if capitalized,

(iii) Residuals (as defined in paragraph (e)(3) of this section) whether or not capitalized,

(iv) Participations (as defined in paragraph (e)(4) of this section) whether or not capitalized, subject to the limitations provided in paragraph (e)(5) of this section, and

(v) All direct production costs described in paragraph (f) of this section. The term "production costs" does not include advertising, marketing, distribution costs, and any cost (other than residuals and participations) that is not capitalized for United States tax purposes. It also does not include any subsequently incurred costs except for the costs described in paragraph (e)(9) of this section.

(3) *Residuals.* The term "residuals", for purposes of section 48(k) and paragraph (e) of this section, means contingent compensation payments (as opposed to payments fixed in amount that will be paid in all events) paid to creative and technical personnel, to

their unions (including guilds) or to pension, health, or welfare funds, pursuant to the terms of collective bargaining agreements betweeen a union and a member of the film industry. A payment which is fixed in amount and payable in all events will not be characterized as a contingent compensation payment merely because it may be applied against an obligation to make a contingent compensation payment. The collective bargaining agreements generally cover all films produced over a period of several years. For example, the conditions which fix the amount of residuals payable in any instance may be based upon a percentage of gross receipts of the film or upon the number of times the film has been broadcast in a particular market.

(4) *Participations.* The term "participations" for purposes of section 48(k) and paragraph (e) of this section means contingent compensation payments, paid for the services of actors, production personnel, writers, composers, directors and producers for their services in connection with the production of the film. The terms of participations generally are negotiated on a film-by-film basis. The amount of a participation due in any case generally is based upon the gross income or net income of the film. Participations do not include any payment which represents a distribution of profits to a person on the basis of an ownership interest. However, the mere fact that a payment is contingent on the net profits derived from the exhibition of a film does not mean that the payment is based on an ownership interest.

(5) *Limitations.* Notwithstanding any other provision of this paragraph, the term "production costs" does not include participations, paid during the taxable year, with respect to all qualified films placed in service by the taxpayer during a particular taxable year, to the extent that such participations exceed the lesser of:

(i) The sum of 25 percent of each participation paid to each person (excluding that part of any participation payable to one person in excess of $1,000,000 for one qualified film) for each qualified film placed in service during the same particular taxable year; or

(ii) Twelve and one-half percent of the aggregate United States production costs determined under paragraph (e)(1) of this section (other than residuals described in paragraph (e)(3) of this section and participations described in paragraph (e)(4) of this section) of all qualified films placed in service during the same particular taxable year.

(6) *Rules with respect to the 25-percent limitation.* In applying paragraph (e)(5)(i) of this section in taxable years after qualified films were placed in service, participations paid in all prior years on the films placed in service in the same taxable year are taken into account. Thus, if films X and Y were placed in service in 1975 and participations of $100 on film X and $40 on film Y were paid in 1975 and participations of $20 on film X and $16 on film Y were paid in 1976, the 25-percent limitation would limit participations includible in production costs with respect to all films placed in service in 1975 to a maximum of $44 (25 percent of $176 ($100+$40+$20+$16)). If paragraph (e)(5)(i) of this section limits total includible participations for all qualified films placed in service during a particular taxable year, the includible participations with respect to each qualified film placed in service in that year will be 25 percent of each participation paid during the taxable year (excluding that part of any participation payable to one person in excess of $1,000,000) with respect to each of these qualified films. Accordingly, under the example in this subparagraph, if the $44 amount is less than the limitation computed under paragraph (e)(5)(ii) of this section, participations taken into account under section 48(k)(5)(B)(vi) in 1976, for films placed in service in 1975, is $9 (25 percent of ($20+$16)).

(7) *Rules with respect to the 12½-percent limitation.* If paragraph (e)(5)(ii) of this section limits total includible participations for all qualified films placed in service during a particular taxable year, the includible participations with respect to films placed in service in that year will be 12½ percent of the taxpayer's aggregate qualified United States production costs (other than residuals and participa-

tions) of those films, reduced by participations includible in production costs in prior years with respect to those films. In such a case, includible participations with respect to each such qualified film shall be determined by apportioning total includible participations pro rata among all qualified films placed in service in the particular taxable year on the basis of total participation paid with respect to each such qualified film, taking into account no more than $1,000,000 in participations for any one individual with respect to any one film. If participations are based on the income from a group of films, for purposes of applying the 12½-percent limitation and the $1,000,000 limitation, participations will be allocated among the films in the group on any reasonable basis that is satisfactory to the district director. In determining includible participations under paragraph (e)(5)(ii) of this section in taxable years after a qualified film has been placed in service, costs of preparing prints described in paragraph (f)(1)(ii) of this section are taken into account.

(8) *Examples.* Paragraph (e)(5) of this section may be illustrated by the following examples:

Example (1). (a) X, a corporation using a calendar taxable year, produced two motion picture films entirely within the United States, film L and film M, and placed them both in service in 1975. Corporation X incurred $5,750,000 in aggregate production costs other than residuals and participations in producing film L and $565,000 in aggregate production costs other than residuals and participations in producing film M. On December 31, 1975, $1,250,000 in residuals and $2,000,000 in participations were paid in connection with film L and $25,000 in residuals and $10,000 in participations were paid in connection with film M. Participations paid in connection with film L consisted of $1,100,000 paid to the starring actor and $900,000 paid to the director. All participations paid in connection with film M were paid to one actor.

(b) The 25-percent limitation on participations in paragraph (e)(5)(i) of this section would limit participations includible in production costs to a maximum of $475,000 with respect to film L. This amount consists of $250,000 (25 percent of $1,000,000 ($1,100,000 participation paid to the starring actor—$100,000 paid in excess of $1,000,000)) plus $225,000 (25 percent of the $900,000 participation paid to the director). The 25-percent limitation would limit participations with respect to film M to $2,500 (25 percent of the $10,000). The 25-percent limitation would limit participations includible in production costs with respects to all film placed in service in 1975 to a maximum of $477,500 ($475,000 plus $2,500).

(c) The 12½-percent limitation on participations in paragraph (e)(5)(ii) of this section would limit participations includible in production costs with respect to all films placed in service in 1975 to a maximum of $789,375 (12½ percent of $6,315,000 ($5,750,000 in aggregate production costs of film L other than residuals and participations +$565,000 in aggregate production costs of film M other than residuals and participations)).

(d) Under paragraph (e)(5) of this section, the lower limit on participations in paragraph (b) of this example applies to limit the participations includible in production costs on December 31, 1975, to $475,000 for film L and $2,500 for film M. Production costs to be taken into account in 1975 for film L are $7,475,000 ($5,750,000 in aggregate production costs other than residuals and participations plus $1,250,000 in residuals and $475,000 for includible participations). Production costs to be taken into account in 1975 for film M are $592,500 ($565,000 in aggregate production costs other than residuals and participations plus $25,000 in residuals and $2,500 for includible participations). The cumulative unused balance of includible participations, for films placed in service in 1975, available for future years under the 12½-percent limitation, at the end of 1975, is $311,875 ($789,375−$477,500).

Example (2). (a) The facts are the same as in example (1) except that in 1976 an additional $20,000 in residuals and $10,000 in participations were paid with respect to film L. In addition, corporation X produced film N entirely within the United States and placed it in service. Corporation X incurred $750,000 in aggregate production costs other than residuals and participations in producing film N. On December 31, 1976, $25,000 in residuals and $25,000 in participations were paid in connection with film N. All participations paid in connection with film L were paid to the director and all participations paid in connection with film N were paid to the starring actor.

(b) The 25-percent limitation on participations in paragraph (e)(5)(i) of this section would limit participations includible in production costs with respect to all films placed in service in 1975 to a maximum of $480,000 ($475,000 for includible participations under paragraph (e)(5)(i) of this section in 1975 with respect to film L plus $2,500 for includible participations under paragraph (e)(5)(i) of this section in 1975 with respect to film

M plus $2,500 (25 percent of the $10,000 participations paid in 1976 for film L)). It would also limit participations includible in production costs with respect to all films placed in service in 1976 to a maximum of $6,250 (25 percent of the $25,000).

(c) The 12½-percent limitation on participations in paragraph (e)(5)(ii) of this section would limit additional participations includible in production costs with respect to all films places in service in 1975 (films L and M) to a maximum of $311,875 (See computation in paragraph (d) of Example (1).) It would also limit production costs with respect to the only film places in service in 1976 (film N) to a maximum of $93,750 (12½ percent of $750,000 in aggregate production costs other than residuals and participations).

(d) Under paragraph (e)(5) of this section, the lower limit on participations in paragraph (b) of this example applies to limit the participations includible in production costs on December 31, 1976, to $2,500 for film L and $6,250 for film N. Total production costs to be taken into account by corporation X in 1976 are $22,500 ($20,000 in residuals + $2,500 in participations) for film L and $781,250 ($750,000 in aggregate production costs other than residuals and participations + $25,000 in residuals and $6,500 in includible participations) for film N. The cumulative unused balance of includible particiaptions, for films placed in service in 1975, available for future years under the 12½-percent limitation, at the end of 1976, is $309,375 ($789,375 − ($477,500 + $2,500)). The balance for film N, placed in service in 1976, is $87,500 ($93,750 − $6,250).

Example (3). (a) The facts are the same as in examples (1) and (2) except that in 1977 an additional $250,000 in residuals and $700,000 in participations were paid with respect to film N. In addition, corporation X produced film O and P entirely within the United States and placed them in service in 1977. Corporation X incurred $1,000,000 in aggregate production costs other than residuals and participations in producing film O and $500,000 in aggregate production costs other than residuals and participations in producing film P. On December 31, 1977, $200,000 in residentials and $1,000,000 in participations were paid in connection with film O and $100,000 in residuals and $300,000 in participations were paid in connection with film P. Participations paid in connection with films N, O, and P were all paid to the starring actor of each film.

(b) The 25-percent limitation on participations in paragraph (e)(5)(i) of this section would limit participations includible in production costs with respect to all films placed in service in 1976 to a maximum of $181,250 ($6,250 in participations included in 1976 with respect to film N plus $175,000 (25 percent of the $700,000 participation paid in 1977 for film N)). It would also limit participations includible in production costs with respect to all films placed in service in 1977 to a maximum of $250,000 (25 percent of the $1,000,000 participation paid to the starring actor) with respect to film O and $75,000 (25 percent of the $300,000 participation paid to the starring actor) with respect to film P.

(c) The 12½ percent limitation on participations in paragraph (e)(5)(ii) of this section would limit additional participations includible in production costs with respect to all films placed in service in 1976 (film N) to a maximum of $87,500. (See computation in paragraph (d) of Example (2)). It would also limit participations includible in production costs with respect to all films placed in service in 1977 to a maximum of $187,500 (12½ percent of $1,500,000 ($1,000,000 in aggregate production costs of film O other than residuals and participations plus $500,000 in aggregate production costs of film P other than residuals and participations)).

(d) Under paragraph (e)(5) of this section, the lower limit on participations in paragraph (c) of this example applies to limit the participations includible in production costs on December 31, 1977, to $87,500 for all films placed in service in 1976 and to $187,500 for all films placed in service in 1977. No additional payments of participations with respect to films placed in service in 1976 or 1977 are includible in production costs.

(9) *Subsequently incurred costs.* The only costs incurred after a qualified film has been placed in service which are includible in production costs are the cost of preparing prints placed in service within 12 months after the film (or part) is initially released for public exhibition in any medium, residuals described in paragraph (e)(3) of this section, and participations described in paragraph (e)(4) of this section. Thus, the cost of additions, modifications, or editing of a film for a new medium incurred after the film is placed in service, is not includible in production costs.

(f) *Direct production costs*—(1) *Definition.* The term "direct production costs", for purposes of section 48(k)(5), includes the following capitalized costs:

(i) Compensation for services performed by actors, production personnel, writers, composers, directors, and producers (not including participations and residents),

(ii) The cost of preparing prints placed in service (as described in

§ 1.46-3(d)) within 12 months after the qualified film is intially released for public exhibition in any medium (excluding the cost of distributing those prints),

(iii) The cost of equipment and supplies, and related shipping costs,

(iv) The cost of costumes, props, scenery, and all accessories,

(v) Any rental charges other than overhead,

(vi) The cost of film editing,

(vii) Per diem and other living allowances for all personnel involved in the motion picture production, and

(viii) Travel expenses for personnel.

The term does not include any cost described in paragraph (e)(2)(i) through (e)(2)(iv) of this section or any cost which is not includible in the term "production costs".

(2) *Allocation of direct production costs.* For purposes of section 48(k)(5) of the Code and paragraph (e)(1) of this section, direct production costs are characterized as either direct production costs allocable to the United States or direct production costs allocable outside the United States, under the following rules:

(i) Compensation paid for services (including fringe benefits) is allocated to the country in which the services are performed, except that payments to United States persons (within the meaning of section 7701(a)(30) of the Code) for services performed outside the United States are allocated to the United States. For purposes of this subparagraph (2), and expense described in paragraph (f)(2) (iii) or (iv) of this section will be treated as compensation and not subject to the allocation rules described therein, to the extent that the expense is treated by the taxpayer as compensation paid to an employee and as wages to the employee for purposes of witholding under chapter 24 (relating to collection of income tax at source on wages). Payments to an electing small business corporation (within the meaning of section 1371) or to a partnership are considered payments to a United States person only to the extent that the payments are included in the gross income of a United States person other than an electing small business corporation or partnership. Payments to a domestic corporation, other than an electing small business corporation, are not considered payments to a United States person to the extent of the value of services provided by the corporation which are performed by persons who are not United States persons.

(ii) All printing costs (within the meaning of section 48(k)(B)(ii) and paragraph (f)(1)(ii) of this section) are allocated to the country in which the costs are incurred.

(iii) Per diem and other living allowances are allocated to the country in which the expenses are incurred.

(iv) Travel expenses for personnel are apportioned one-half to direct production costs allocable to the country of departure and one-half to direct production costs allocable to the country of arrival.

(v) Amounts for equipment, supplies, and related shipping costs are allocated to the country in which, with respect to the production of the film, the predominant use occurs. In the absence of better evidence as to the actual place of predominant use, allocations may be made in accordance with the shooting days of the film.

(vi) All other items are allocated consistent with the principle set forth in section 48(k)(5)(D)(ii) and paragraph (f)(2)(v) of this section.

(g) *Entitlement to investment credit by taxpayers other than original owner*—(1) *Purchase or sale of a qualified film.* If a taxpayer purchases an entire qualified film before it is placed in service, the purchaser's qualified United States production costs are equal to the lesser of the total qualified United States production costs of the seller or the fixed purchase price of the film. If a taxpayer purchases a part of a film before it is placed in service, the purchaser's qualified United States production costs are equal to the lesser of (i) the qualified United States production costs of the seller at the time of the sale or at the time of completion if later, reduced by the amount of any prior purchase, or (ii) the fixed purchase price of that part of the film purchased. Notwithstanding the preceding sentences, in determining a purchaser's qualified

United States production costs, the purchaser of a qualified film may include subsequently incurred costs (as described in paragraph (e)(9) of this section) which he incurs. If a taxpayer purchases one or more parts of a film, and in the same transaction acquires an interest in the film that does not constitute a part, the fixed purchase price for purposes of this subparagraph (1) is reduced by the amount paid attributable to the interest. If a taxpayer sells a part of a film before the film is placed in service, his qualified United States production costs are reduced by the fixed purchase price of that part of the qualified film sold. For example, assume a producer sells, for $75, all rights to display a film in Europe. The total qualified United States production costs for the film were $100. The producer's qualified United States production costs for that part of the film retained are $25 ($100 in total qualified United States production costs for the whole film reduced by the $75 purchase price).

(2) *Purchases before January 20, 1978.* For a qualified film purchased before January 20, 1978,—

(i) The district director may require the purchaser to establish the seller's qualified United States production costs. If the purchaser informs the district director in writing that the purchaser does not know, and after making reasonable efforts cannot establish those costs, then the district director may establish them by making appropriate inquiries of the seller or any other person. (See paragraph (e)(2) of this section which requires that all production costs other than residuals and participations be capitalized for United States tax purposes by the producer.)

(ii) If the seller's qualified United States production costs cannot be established, the amount of those costs will be presumed to equal the amount of the fixed purchase price: *Provided,* The purchaser can show that the film was produced entirely in the United States. Absent such a showing, the purchaser must establish the seller's qualified United States production costs on the basis of a reasonable estimate.

(3) *Purchases after January 19, 1978.* For a qualified film purchased after January 19, 1978, no credit is allowable unless the purchaser attaches to its income tax return in which the credit is claimed, a statement addressed to the district director, signed by the seller which (i) describes the nature and an amount of each item qualifying as United States production costs, (ii) specifies the nature and purchase price of any part of the film previously sold, and (iii) states that the seller has not previously placed the film in service. If prior to December 20, 1977, a person has entered into a binding contract to purchase a qualified film, the qualified film will be regarded as having been purchased prior to January 20, 1978.

(4) *Credit unavailable to lessees.* The election under section 48 (d) by which a lessor of property may elect to treat a lessee as having acquired the property is not available with respect to a qualified film. To obtain the credit with respect to a film a taxpayer must acquire full rights to exploit a qualified film for its estimated useful life through at least a particular medium in a particular geographical area. Furthermore, the amount with respect to which the credit may be claimed is limited by the amount that the taxpayer has at risk. Under paragraph (a) of this section, a taxpayer who possesses such rights and is at risk is an owner of a part, irrespective of the term used to characterize the taxpayer in any private agreement of contract. Accordingly, a taxpayer who meets these requirements is entitled to the credit without the use of section 48 (d). If a lessee does not meet these requirements, a lessor cannot elect under section 48 (d) to treat the lessee as having acquired the film. For example, where a taxpayer is precluded (by law, regulation or government action) from acquiring a part of a film and thus can only lease the film, the lessor cannot elect under section 48 (d) to treat the lessee as having acquired the film.

(Secs. 38(b) and 7805, Internal Revenue Code of 1954 (76 Stat. 962, 68A Stat. 917; 26 U.S.C. 38(b), 7805))

[44 FR 20417, Apr. 5, 1979]

§ 1.48-9 Definition of energy property.

(a) *General rule*—(1) *In general.* Under section 48(l)(2), energy property means property that is described in at least one of 6 categories of energy property and that meets the other requirements of this section. If property is described in more than one of these categories, or is described more than once in a single category, only a single energy investment credit is allowed. In that case, the energy investment credit will be allowed under the category the taxpayer chooses by indicating the chosen category on Form 3468, Schedule B. The 6 categories of energy property are:

(i) Alternative energy property,

(ii) Solar or wind energy property,

(iii) Specially defined energy property,

(iv) Recycling equipment,

(v) Shale oil equipment, and

(vi) Equipment for producing natural gas from geopressured brine.

(2) *Depreciable property with 3-year useful life.* Property is not energy property unless depreciation (or amortization in lieu of depreciation) is allowable and the property has an estimated useful life (determined at the time when the property is placed in service) of 3 years or more.

(3) *Effective date rules.* To be energy property—

(i) If property is constructed, reconstructed or erected by the taxpayer, the construction, reconstruction, or erection must be completed after September 30, 1978, or

(ii) If the property is acquired, the original use of the property must (A) commence with the taxpayer and (B) commence after September 30, 1978, and before January 1, 1983.

For transitional rules, see section 48(m).

(4) *Cross references.* (i) To determined if depreciation (or amortization in lieu of depreciation) is allowable for property, see § 1.48-1(b).

(ii) For the meaning of "estimated useful life", see § 1.46-3(e)(7).

(iii) The meaning of "acquired", "original use", "construction", "reconstruction", and "erection" is determined under the principles of § 1.48-2(b).

(iv) For the definition of energy investment credit (energy credit), see section 48(o)(2).

(v) For special rules relating to public utility property, see paragraph (n) of this section.

(b) *Relationship to section 38 property*—(1) *In general.* (i) Energy property is treated under section 48(l)(1) as meeting the general requirements for section 38 property set forth in section 48(a)(1). For example, structural components of a building may qualify for the energy credit. In addition, the exclusion from section 38 property under section 48(a)(3) (lodging limitation) does not apply to energy property. For purposes of the energy credit, energy property is treated as section 38 property solely by reason of section 48(l)(1). For example, if property ceases to be energy property, it ceases to be section 38 property for all purposes relating to the energy credit and, thus, if subject to recapture under section 47. See § 1.47-1(h).

(ii) See the effective date rules under paragraph (a)(3) of this section for limitations on the eligibility of property as energy property.

(iii) Section 48(l)(1) does not affect the character of property under sections of the Code outside the investment credit provisions. For example, structural components of a building that are treated as section 38 property under section 48(l)(1) remain section 1250 property and are not section 1245 property.

(2) *Other section 48 rules apply.* (i) In general, section 48(a) otherwise applies in determining if energy property is section 38 property. Thus, energy property excluded from the definition of section 38 property under section 48(a) (except by reason of section 48(a)(1) or (a)(3)) is not eligible for the energy credit. For example, energy property used predominantly outside the United States (section 48(a)(2)) or used by tax exempt organizations (section 48(a)(4)), in general, is not treated as section 38 property for any purpose and thus, is not eligible for the energy credit.

(ii) Other rules of section 48, such as those for leased property under section 48(d), also apply to energy property.

(3) *Regular credit denied for certain energy property.* In computing the amount of credit under section 46(a)(2), the regular percentage does not apply to any energy property which, but for section 48(l)(1), would not be section 38 property. See section 46(a)(2)(D). For example, energy property used for lodging (section 48(a)(3)) and, in general, structural components of a building (section 48(a)(1)(B)) re not eligible for the regular credit even though they may be eligible for the energy credit. However, a structural component of a qualified rehabilitated building (as defined in section 48(g)(1)) or a single purpose agricultural or horticultural structure (as defined in section 48(p)) may qualify for the regular credit without regard to section 48(l)(1).

(c) *Alternative energy property*—(1) *In general.* Alternative energy property means property described in paragraph (c)(3) through (10) of this section. In general alternative energy property includes certain property that uses an alternate substance as a fuel or feedstock or converts an alternate substance to a synthetic fuel and certain associated equipment.

(2) *Alternate substance.* (i) An alternate substance is any substance or combination of substances other than an oil or gas substance. Alternate substances include coal, wood, and agricultural, industrial, and municipal wastes or by-products. Alternate substances do not include synthetic fuels or other products that are produced from an alternate substance and that have undergone a chemical change as described in paragraph (c)(5)(ii) of this section. For example, methane produced from landfills is not an alternate substance; rather it is a synthetic fuel produced from an alternate substance. However, preparing an alternate substance for use as a fuel or feedstock or for conversion into a fuel does not create a new product if no chemical change occurs. For example, pelletizing, drying, compacting, and liquefying do not result in a new product if no chemical change occurs.

(ii) The term "oil or gas substance" means—

(A) oil or gas and

(B) any primary product of oil or gas.

(iii) For the definition of primary product of oil or gas, see § 1.993-3(g)(3)(i), (ii), and (vi). Thus, petrochemicals are not primary products of oil or gas.

(3) *Boiler.* (i) A boiler that uses an alternate substance as its primary fuel is alternative energy property.

(ii) A boiler is a device for producing vapor from a liquid. Boilers, in general, have a burner in which fuel is burned. A boiler includes a fire box, boiler tubes, the containment shell, pumps, pressure and operating controls, and safety equipment, but not pollution control equipment (as defined in paragraph (c)(8) of this section).

(iii) A "primary fuel" is a fuel comprising more than 50 percent of the fuel requirement of an item of equipment, measured in terms of Btu's for the remainder of the taxable year from the date the equipment is placed in service and for each taxable year thereafter. Electricity and waste heat are not fuels. For example, electric boilers do not qualify as alternative energy property even if the electricity is derived from an alternate substance.

(4) *Burners.* (i) A burner for a combustor other than a burner described in paragraph (c)(3)(ii) of this section is alternative energy property if the burner uses an alternate substance as its primary fuel (as defined in paragraph (c)(3)(iii) of this section).

(ii) A burner is the part of a combustor that produces a flame. A combustor is a process heater which includes ovens, kilns, and furnaces.

(iii) A burner includes equipment (such as conveyors, flame control devices, and safety monitoring devices) located at the site of the burner and necessary to bring the alternate substance to the burner.

(5) *Synthetic fuel production equipment.* (i) Equipment (synthetic fuel equipment) that converts an alternate substance into a synthetic solid, liquid, or gaseous fuel (other than coke or coke gas) is alternative energy property. Synthetic fuel production equipment does not include equipment, such as an oxygen plant, that is not directly involved in the treatment of an

alternate substance, but produces a substance that is, like the alternate substance, a basic feedstock or catalyst used in the conversion process. Equipment is not eligible if it is used beyond the point at which a substance usable as a fuel has been produced. Equipment is eligible only to the extent of the equipment's cost or basis allocable to the annual production of substances used as a fuel or used in the production of a fuel. For example, assume for the taxable year that 50 percent of the output of equipment is used to produce alcohol for production of whiskey and 50 percent is used to produce alcohol for use in a fuel mixture, such as gasohol. The alcohol production equipment qualifies as synthetic fuel equipment but only to the extent of one-half of its cost or basis. If, in a later taxable year, the equipment is used exclusively to produce whiskey, all of the equipment ceases to be synthetic fuel equipment.

(ii) A fuel is a material that produces usable heat upon combustion. To be "synthetic", the fuel either must differ significantly in chemical composition, as opposed to physical composition, from the alternate substance used to produce it or, in the case of soiid fuel produced from biomass, the chemical change must consist of defiberization. Examples of synthetic fuels include alcohol derived from coal, peat, and vegetative matter, such as wood and corn, and methane from landfills.

(iii) Synthetic fuel equipment includes coal gasification equipment, coal liquefaction equipment, equipment for recovering methane from landfill, and equipment that converts biomass to a synthetic fuel.

(iv) Synthetic fuel equipment does not include equipment that merely mixes an alternate substance with another substance. For example, synthetic fuel equipment includes neither equipment that mixes coal and water to produce a slurry nor equipment that mixes alcohol and gasoline to produce gasohol. Equipment used to produce coke or coke gas, such as coke ovens, is also ineligible.

(6) *Modification equipment.* (i) Alternative energy property includes equipment (modification equipment) designed to modify existing equipment. For the definition of "existing," see paragraph (l)(1)(i) of this section. To be eligible, the modification must result in a substitution for the remainder of the taxable year from the date the equipment is placed in service and for each taxable year thereafter of the items in paragraph (c)(6)(ii)(A) or (B) of this section for all or a portion of the oil or gas substance used as a fuel or feedstock. As a result of the modification, the substituted alternate substance must comprise at least 25 percent of the fuel or feedstock (determined on the basis of Btu equivalency). If the modification also increases the capacity of the equipment, only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies.

(ii) The substitutes for an oil or gas substance are—

(A) An alternate substance or

(B) A mixture of oil and an alternate substance.

(iii) Modification equipment does not include replacements or a boiler of burner. If the boiler or burner is replaced, the items must be described in paragraph (c) (3) or (4) of this section to qualify as alternative energy property. Modification may include, however, replacements of components of a boiler or burner, such as a heat exchanger.

(iv) The following examples illustrate this paragraph (c)(6).

Example (1). On January 1, 1980, corporation X is using oil to fuel its boiler. On June 1, 1980, X modifies the boiler to permit substitution of a coal and oil mixture for 40 percent of X's oil fuel needs. The mixture consists 75 percent of oil and 25 percent of coal. The equipment modifying the boiler does not qualify as modification equipment because the alternate substance comprises only 10 percent of the fuel.

Example (2). Assume the same facts as in example (1) except 75 percent of the mixture is coal. The equipment modifying the boiler qualifies.

Example (3). Assume the same facts as in example (2) except, instead of substituting an oil and coal mixture for 40 percent of X's oil fuel needs, X uses the modification to expand the boiler's fuel capacity by 40 percent using the mixture as additional fuel. The additional fuel mixture comprises only 28 percent of X's total fuel needs. Thus, even though 75 percent of the additional

fuel mixture is an alternate substance, the boiler does not qualify as modification equipment because the alternate substance comprises only 21 percent of the total fuel.

(7) *Equipment using coal as feedstock.* Equipment that uses coal (including lignite) to produce a feedstock for the manufacture of chemicals, such as petrochemicals, or other products is alternative energy property. Equipment is not eligible if it is not directly involved in the treatment of coal or a coal product, but produces a substance that is, like coal, a basic feedstock or catalyst used in the coal conversion process. Equipment is not eligible if it is used beyond the point at which the first product marketable as a feedstock has been produced. Equipment used to produce coke or coke gas, such as coke ovens, is ineligible.

(8) *Pollution control equipment.* (i) Pollution control equipment is alternative energy property. Eligible equipment is limited to property or equipment to the extent it qualifies as a pollution control facility under section 103(b)(4)(F) and the regulations thereunder except that, if control of pollution is not the only significant purpose (within the meaning of those regulations), only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies. However, if a Treasury decision changes the regulations under section 103(b)(4)(F) and, thus, the rules reflected in this subdivision (i), the rules as changed will apply as of the effective date of the Treasury decision.

(ii) To be eligible, the equipment must be required by a Federal, State, or local government regulation to be installed on, or used in connection with, eligible alternative energy property (as defined in paragraph (c)(8)(v) of this section).

(iii) Under section 48(l)(3)(D) equipment is not eligible if required by a Federal, State, or local government regulation in effect on October 1, 1978, to be installed on, or in connection with, property using coal (including lignite) as of October 1, 1978.

(iv) Under this subparagraph (8), pollution control equipment is required by regulation if it would be necessary to install the equipment to satisfy the requirements of any applicable law, including nuisance law. The pollution control equipment need not be specifically identified in the applicable law. If several different types of equipment may be used to comply with the applicable law, each type of equipment is considered necessary to satisfy the requirements of the law. An order permitting a taxpayer to delay compliance with any applicable law is disregarded.

(v) Under this subparagraph (8) "eligible alternative energy property" is energy property (as defined in section 48 (l)(2)) described in paragraph (c) (3) through (7) of this section. If equipment otherwise qualifying as pollution control equipment is installed on, or used in connection with, both eligible alternative energy property and property other than eligible alternative energy property, only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies.

(vi) *Examples.* The following examples illustrate this subparagraph (8). Assume that the property or equipment in the examples are described in § 1.103-8(g)(2)(ii) and that their only purpose is control of pollution.

Example (1). On October 1, 1978, corporation X acquires and places in service in State A a paper mill. The facility includes a boiler the primary fuel for which is wood chips. The facility includes equipment necessary to comply with pollution control standards in effect on October 1, 1978 in State A. This equipment qualifies as pollution control equipment.

Example (2). On October 1, 1978, corporation Y was burning coal at its facility in State B. The emissions from the facility exceeded State air pollution control requirements in effect on October 1, 1978. On January 1, 1979, X installed cyclone separators to comply with the State pollution control requirements. The cyclone separators do not qualify as pollution control equipment.

Example (3). Assume the same facts as in example (2) except that Y installs a baghouse instead of cyclone separators to meet more stringent standards that take effect on December 31, 1978. The baghouse qualifies as pollution control equipment because the baghouse was not necessary to meet the standards in effect on October 1, 1978.

Example (4). On October 1, 1978, corporation Z is burning coal at its facility in State C. The emissions from that facility exceed

State air pollution control standards in effect on October 1, 1978. C orders Z to install cyclone separators before January 1, 1979. However, C allows Z to operate its facility until January 1, 1979, under less stringent interim standards applicable only to Z. The separators do not qualify as pollution control equipment. The delayed compliance order is disregarded.

(9) *Handling and preparation equipment.* (i) Alternative energy property includes equipment (handling and preparation equipment) used for unloading, transfer, storage, reclaiming from storage, or preparation of an alternate substance for use in eligible alternative energy property (as defined in paragraph (c)(9)(ii) of this section). Handling and preparation equipment must be located at the site the alternate substance is used as a fuel or feedstock. For example, equipment used to screen and prepare coal for use at a power plant qualifies if located at the plant. However, similar equipment located at the coal mine would not qualify.

(ii) Under this subparagraph (9), "eligible alternative energy property" is energy property (as defined in section 48(l)(2)) described in paragraph (c) (3) through (8) of this section. If equipment otherwise qualifying as handling and preparation equipment is installed on, or used in connection with, property other than eligible alternative energy property, only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies.

(iii) The term "preparation" includes washing, crushing, drying, compacting, and weighing of an alternate substance. Handling and preparation equipment also includes equipment for shredding, chopping, pulverizing, or screening agricultural or forestry byproducts at the site of use.

(iv) Handling and preparation equipment does not include equipment, such as coal slurry pipelines and railroad cars, that transports a fuel or a feedstock to the site of its use.

(10) *Geothermal equipment.* (i) Alternative energy property includes equipment (geothermal equipment) that produces, distributes, or uses energy derived from a geothermal deposit (as defined in § 1.44C-2(h)).

(ii) In general, production equipment includes equipment necessary to bring geothermal energy from the subterranean deposit to the surface, including well-head and downhole equipment (such as screening or slotted liners, tubing, downhole pumps, and associated equipment). Reinjection wells required for production also may qualify. Production does not include exploration and development.

(iii) Distribution equipment includes equipment that transports geothermal steam or hot water from a geothermal deposit to the site of ultimate use. If geothermal energy is used to generate electricity, distribution equipment includes equipment that transports hot water from the geothermal deposit to a power plant. Distribution equipment also includes components of a heating system, such as pipes and ductwork that distribute within a building the energy derived from the geothermal deposit.

(iv) Equipment that uses energy derived from a geothermal deposit is eligible only if it uses geothermal energy exclusively. Thus, geothermal equipment does not include equipment that uses energy derived both from a geothermal deposit and from sources other than a geothermal deposit. However, the existence of a backup system designed for use only in the event of a failure in the system providing energy derived from a geothermal deposit will not disqualify any other equipment. For example, radiators, fan-coil units, and baseboard heaters are not eligible if they are used in a particular application with hot water from sources other than a geothermal deposit. If geothermal energy is used to generate electricity, equipment using geothermal energy includes the electrical generating equipment, such as turbines and generators. However, geothermal equipment does not include any electrical transmission equipment, such as transmission lines and towers, or any equipment beyond the electrical transmission stage, such as transformers and distribution lines.

(v) *Examples.* The following examples illustrate this subparagraph (10):

Example (1). In 1979, corporation X installs a system which heats its office build-

ing by circulating hot water heated by energy derived from a geothermal deposit through the building. Geothermal equipment includes the circulation system, including the pumps and pipes which circulate the hot water through the building.

Example (2). The facts are the same as in example (1), except that corporation X also installs a boiler to produce hot water for heating the building exclusively in the event of a failure of the geothermal equipment. Such a boiler is not geothermal equipment, but the existence of such a backup system does not serve to disqualify property eligible in example (1).

Example (3). The facts are the same as in example (1), except that the water heated by energy derived from a geothermal deposit is not hot enough to provide sufficient heat for the building. Therefore, X installs a system in which the water is heated by an electric boiler before being circulated in the heating system. In this case, neither the boiler nor the circulating system is considered to be geothermal equipment.

Example (4). Corporation Y acquires a commercial vegetable dehydration system in 1981. The system operates by placing fresh vegetables on a conveyor belt and moving them through a dryer. The conveyor belt is powered by electricity. The dryer uses solely energy derived from a geothermal deposit. The dryer is geothermal equipment while the equipment powered by electricity does not qualify.

(d) *Solar energy property*—(1) *In general.* Energy property includes solar energy property. The term "solar energy property" includes equipment and materials (and parts solely related to the functioning of such equipment) that use solar energy directly to (i) generate electricity, (ii) heat or cool a building or structure, or (iii) provide hot water for use within a building or structure. Generally, these functions are accomplished through the use of equipment such as collectors (to absorb sunlight and create hot liquids or air), storage tanks (to store hot liquids), rockbeds (to store hot air), thermostats (to activate pumps or fans which circulate the hot liquids or air), and heat exchangers (to utilize hot liquids or air to create hot air or water). Property that uses, as an energy source, fuel or energy derived indirectly from solar energy, such as ocean thermal energy, fossil fuel, or wood, is not considered solar energy property.

(2) *Passive solar excluded* (i) Solar energy property excludes the materials and components of "passive solar systems," even if combined with "active solar systems."

(ii) An active solar system is based on the use of mechanically forced energy transfer, such as the use of fans or pumps to circulate solar generated energy.

(iii) A passive system is based on the use of conductive, convective, or radiant energy transfer. Passive solar property includes greenhouses, solariums, roof ponds, glazing, and mass or water trombe walls.

(3) *Electric generation equipment.* Solar energy property includes equipment that uses solar energy to generate electricity, and includes storage devices, power conditioning equipment, transfer equipment, and parts solely related to the functioning of those items. In general, this process involves the transformation of sunlight into electricity through the use of such devices as solar cells or other collectors. However, solar energy property used to generate electricity includes only equipment up to (but not including) the stage that transmits or uses electricity.

(4) *Pipes and ducts.* Pipes and ducts are solar energy property if used exclusively to carry energy derived from solar energy.

(5) *Specially adopted equipment.* Equipment that uses solar energy beyond the distribution stage is eligible only if specially adopted to use solar energy.

(6) *Auxiliary equipment.* Solar energy property does not include equipment (auxiliary equipment), such as furnaces and hot water heaters, that use a source of power other than solar or wind energy to provide usable energy. Solar energy property also does not include equipment, such as ducts and hot water tanks, whether utilized solely by auxiliary equipment or by both auxiliary equipment and solar energy equipment.

(7) *Solar process heat equipment.* Solar energy property does not include equipment that uses solar energy to generate steam at high temperatures for use in industrial or commercial processess (solar process heat).

(8) *Example.* The following example illustrates this paragraph (d).

Example. (a) In 1979, corporation X constructs an apartment building and purchases equipment to convert solar energy into heat for the building. Corporation X also installs an oil-fired water heater and other equipment to provide a backup source of heat when the solar energy equipment cannot meet the energy needs of the building.

(b) The items purchased in addition to the water heater include a roof solar collector, a heat exchanger, a hot water tank, a control component, pumps, pipes, fan-coil units, and valves. Assume the fan-coil units could be used with energy derived from an oil or gas substance without significant modification. All items are depreciable and have a useful life of three years or more. The use of the equipment to heat the building is the first use to which the equipment has been put.

(c) Water is pumped from the basement through pipes to the roof solar collector. Heated water returns through pipes to a heat exchanger which transfers heat to the water in the hot water tank.

(d) The hot water tank and the oil-fired water heater utilize the same distribution pipe. Pumps and valves at the points of connection between the hot water tank, the oil-fired water heater, and the distribution pipe regulate the auxiliary energy supply use. They also prevent the oil-fired water heater from heating water in the hot water tank.

(e) An integrated control component determines whether hot water from the hot water tank or from the oil-fired water heater is distributed to fan-coil units located throughout the building.

(f) The roof solar collector is solar energy property. The pump that moves the water to the roof collector and the pipes between the roof collector and the hot water tank qualify because they are solely related to transporting solar heated water. The hot water tank qualifies because it stores water heated solely by solar radiation. The heat exchanger also qualifies.

(g) The oil-fired water heater does not qualify as solar energy property because it is auxiliary equipment.

(h) The distribution pipe, the control component, and the pumps and valves do not qualify because they serve the oil-fired water heater as well as the solar energy equipment. All of these items would qualify if used solely in connection with solar energy equipment. The fan-coil units do not qualify because they are not specially adapted to use energy derived from solar energy.

(e) *Wind energy property*—(1) *In general.* Energy property includes wind energy property. Wind energy property is equipment (and parts solely related to the functioning of that equipment) that performs a function described in paragraph (e)(2) of this section. In general, wind energy property consists of a windmill, wind-driven generator, storage devices, power conditioning equipment, transfer equipment, and parts solely related to the functioning of those items. Wind energy property does not include equipment that transmits or uses electricity derived from wind energy. In addition, limitations apply similar to those set forth in paragraph (d)(5) and (6) of this section.

(2) *Eligible functions.* Wind energy property is limited to equipment (and parts related solely to the functioning of that equipment) that—

(i) Uses wind energy to heat or cool, or provide hot water for use in, a building or structure, or

(ii) Uses wind energy to generate electricity (but not mechanical forms of energy).

(f) *Specially defined energy property*—(1) *In general.* Specially defined energy property means only those items described in paragraph (f) (4) through (14) of this section that meet the requirements of paragraph (f)(2) of this section. The items described in paragraph (f) (4) through (14) of this section also consist of related equipment, such as fans, pumps, ductwork, piping, and controls, the installation of which is necessary for the specified item to reduce the energy consumed or heat wasted by the process.

(2) *General requirements.* To be eligible, each item described in paragraph (f) (4) through (14) of this section must be installed in connection with an existing industrial or commercial facility. In addition, the principal purpose of each of those items must be reduction of energy consumed or heat wasted in any existing industrial or commercial process. See section 48(l)(10) and paragraph (l) of this section. If an item performs more than one function, only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies.

(3) *Industrial or commercial process.* (i) A process is a means or method of producing a desired result by chemical, physical, or mechanical action. For example, equipment installed in connection with retail sales, general

office use, and residential use are not used in a process within the meaning of this paragraph (f)(3).

(ii) An industrial process includes agricultural processes and thermal processes relating to production or manufacture, such as those involving boilers and furnaces.

(iii) A commercial process includes laundering and food preparation.

(iv) More than one process may be conducted in a single facility. The fact that several processes involved in the production of a product are integrated does not cause such integrated processes to be treated as one process. For example, in a food canning facility, producing prepared food from fresh vegetables is not one process but rather an integration of several processes including washing, cooking and canning.

(v) The following example illustrates this paragraph (f)(3).

Example. Corporation X, an advertising agency, acquires an automatic energy control system designed to reduce energy consumed by heating and cooling its office building. Although the use of an office for X's business is a commercial activity, heating or cooling an office is not an industrial or commercial process. The automatic energy control system does not qualify because it does not reduce energy consumed in an industrial or commercial process.

(4) *Recuperators.* Recuperators recover energy, usually in the form of waste heat from combustion exhaust gases, hot exiting product, or product cooling air, that is used to heat incoming combustion air, raw materials, or fuel. Recuperators are configurations of equipment consisting in part of fixed heat transfer surfaces between two gas flows, and include related baffles, dividers, entrance flanges, transition sections, and shells or cases enclosing the other components of the recuperator. In general, a fixed heat transfer surface absorbs heat from a gas or liquid flow or dissipates heat to the gas or liquid flow.

(5) *Heat wheels.* Heat wheels recover energy, usually in the form of waste heat, from exhaust gases to preheat incoming gases. Heat wheels are items of equipment consisting in part of regenerators (which rotate between two gas flows) and related drive components, wiper seals, entrance flanges, and transition sections.

(6) *Regenerators.* Regenerators are devices, such as clinker columns or chains, that recover energy by efficiently storing heat while exposed to high temperature gases and releasing heat while exposed to low temperature gases, fluids, or solids.

(7) *Heat exchangers.* Heat exchangers recover energy, usually in the form of waste heat, from high temperature gases, liquids, or solids for transfer to low temperature gases, liquids, or solids. Heat exchangers consist in part of fixed heat transfer surfaces (described in paragraph (f)(4) of this section) separating two media. Heat exchange equipment does not include fluidized bed combustion equipment.

(8) *Waste heat boilers.* Waste heat boilers use waste heat, usually in the form of combustion exhaust gases, as a substantial source of energy. A substantial source of energy is one that comprises more than 20 percent of the energy requirement on the basis of Btu's during the course of each taxable year (including the start-up year).

(9) *Heat pipes.* Heat pipes recover energy, usually in the form of waste heat, from high temperature fluids to heat low temperature fluids. A heat pipe consists in part of sealed heat transfer chambers and a capillary structure. In general, the heat transfer chambers alternatively vaporize and condense a working fluid as it passes from one end of the chamber to the other.

(10) *Automatic energy control systems.* Automatic energy control systems automatically reduce energy consumed in an industrial or commercial process for such purposes as environmental space conditioning (*i.e.*, lighting, heating, cooling or ventilating, etc.). Automatic energy control systems include, for example, automatic equipment settings controls, load shedding devices, and relay devices used as part of such system. Property such as computer hardware installed as a part of the energy control system also qualifies, but only to the extent of its incremental cost (as defined in paragraph (k) of this section).

(11) *Turbulators.* Turbulators increase the rate of transfer of heat

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from combustion gases to heat exchange surfaces by increasing the turbulence in the gases. A turbulator is a baffle placed in a boiler firetube or in a heat exchange tube in industrial process equipment to deflect gases to the heat transfer surface.

(12) *Preheaters.* Preheaters recover energy, usually in the form of waste heat, from either combustion exhaust gases or steam, to preheat incoming combustion air or boiler feedwater. A preheater consists in part of fixed heat transfer surfaces (described in paragraph (f)(4) of this section) separating two fluids.

(13) *Combustible gas recovery systems.* Combustible gas recovery systems are items of equipment used to recover unburned fuel from combustion exhaust gases.

(14) *Economizers.* Economizers are configurations of equipment used to reduce energy demand or recover energy from combustion exhaust gases and other high temperature sources to preheat boiler feedwater.

(15) *Other property added by the Secretary.* [Reserved]

(g) *Recycling equipment*—(1) *In general.* Recycling equipment is equipment used exclusively to sort and prepare, or recycle, solid waste (other than animal waste) to recover usable raw materials ("recovery equipment"), or to convert solid waste (including animal waste) into fuel or other useful forms of energy ("conversion equipment"). Recycling equipment may include certain other onsite related equipment.

(2) *Recovery equipment.* Recovery equipment includes equipment that—

(i) Separates solid waste from a mixture of waste,

(ii) Applies a thermal, mechanical, or chemical treatment to solid waste to ensure the waste will properly respond to recycling, or

(iii) Recycles solid waste to recover usable raw materials, but not beyond occurrence of the first of the following:

(A) The point at which a material has been created that can be used in beginning the fabrication of an end-product in the same way as materials from a virgin substance. Examples are the fiber stage in textile recycling, the newsprint or paperboard stage in paper recycling, and the ingot stage for other metals (other than iron and steel). In the case of recycling iron or steel, recycling equipment does not include any equipment used to reduce solid waste to a molten state or any process thereafter.

(B) The point at which the material is a marketable product (*i.e.*, has a value other than for recycling) even if the material is not marketed by the taxpayer at that point.

(3) *Conversion equipment.* Conversion equipment includes equipment that converts solid waste into a fuel or other usable energy, but not beyond the point at which a fuel, steam, electricity, hot water, or other useful form of energy has been created. Thus, combustors, boilers, and similar equipment may be eligible if used for a conversion process, but steam and heat distribution systems between the combustor or boiler and the point of use are not eligible.

(4) *On-site related equipment.* Recycling equipment also includes onsite loading and transportation equipment, such as conveyors, integrally related to other recycling equipment. This equipment may include equipment to load solid waste into a sorting or preparation machine and also a conveyor belt system that transports solid waste from preparation equipment to other equipment in the recycling process.

(5) *Solid waste.* (i) The term "solid waste" has the same meaning as in § 1.103-8(f)(2)(ii)(*b*), subject to the following exceptions and the other rules of this subparagraph (5):

(A) The date the equipment is placed in service is substituted in the first sentence of § 1.103-8(f)(2)(ii)(*b*) for the date of issue of the obligations, and

(B) Material that has a market value at the place it is located only by reason of its value for recycling is not considered to have a market value.

(ii) Solid waste may include a nominal amount of virgin materials, liquids, or gases, not to exceed 10 percent. If more than 10 percent of the material recycled during the course of any taxable year (including the "start up" year) consists of virgin material, liquids, or gases, the equipment ceases to

be energy property and is subject to recapture under section 47. The determination of the portion of virgin material, liquids, or gases used is based on volume, weight, or Btu's whichever is appropriate.

(6) *Ineligible equipment.* Transportation equipment, such as trucks, that transfer solid waste between geographically separated sites (*e.g.*, the collection point and the recycling point) is not eligible. Steam and heat distribution systems are also ineligible.

(7) *Increased recycling capacity.* If the equipment both replaces recycling capacity and increases that capacity at a particualr site, only the incremental cost (as defined in paragraph (k) of this section) of increasing the capacity qualifies. Recycling capacity is determined by the ability to produce a product not previously produced by the taxpayer, or more of an existing product, in a way that does not lower overall production.

(8) *Examples.* The following examples illustrate this paragraph (g).

Example (1) Corporation W recycles aluminum scrap metal. W owns a junk yard where it collects and crushes the metal into compact units. W's trucks bring the scrap metal from the junk yard to its main plant located 3 miles away. W's furnace equipment at the main plant reduces the scrap to the molten state and W's rolling equipment rolls the aluminum into sheets. The furnace qualifies, but for two separate reasons the rolling equipment does not qualify. First, the molten aluminum would be a marketable product if reduced to ingots prior to rolling. It is not necessary that W actually reduce the molten aluminum to ingots. Second, the molten aluminum could be used in the same way as virgin material.

Example (2) Corporation X manufactures newsprint using wood chips discarded during X's lumber operations. Assume X could sell the wood chips to other companies located a short distance from X's mill for use as a fuel. None of the equipment used to manufacture the newsprint qualifies.

Example (3) Assume the same facts as in example (2) except X uses old newspapers which have no value except for recycling in the area where X's mill is located. The equipment qualifies.

Example (4) Corporation Y recycles municipal waste. Assume the municipal waste is "solid waste" under paragraph (g)(5) of this section. During the first taxable year Y operates the equipment, Y uses 8,500 pounds of municipal waste and 1,500 pounds of virgin material and liquids. No energy credit is allowed for the equipment.

Example (5) Corporation Z owns a waste recovery facility. The corrugated paper portion of the waste stream is picked off a conveyor as it enters the facility. The corrugated paper is baled and sold as a secondary paper product. Z acquires shredding and air-classification equipment. Corrugated paper that is not removed from the conveyor belt enters the new equipment for production as a fuel. Z increases the input of corrugated paper so that the same amount of corrugated paper is removed from the conveyor to be baled. The excess paper that is not removed for baling enters the shredding and air-classification equipment. The new equipment qualifies.

(h) *Shale oil equipment*—(1) *In general.* Shale oil equipment used in mining or either surface or *in situ* processing qualifies as energy property. Shale oil equipment means equipment used exclusively to mine, or produce or extract oil from, shale rock.

(2) *Eligible processes.* In general, processing equipment qualifies if used in or after the mining stage and up through the retorting process. Thus, eligible processes include crushing, loading into the retort, and retorting, but not hydrogenation, refining, or any process subsequent to retorting. However, with respect to *in situ* processing, eligible processes include creating the underground cavity.

(3) *Eligible equipment.* Shale oil equipment includes—

(i) Heading jumbos, bulldozers, and scaling and bolting rigs used to create an underground cavity for *in situ* processing,

(ii) On-site water supply and treatment equipment and handling equipment for spent shale.

(iii) Crushing and screening plant equipment, such as hoppers, feeders, vibrating screens, and conveyors,

(iv) Briquetting plant equipment, such as hammer mills and vibratory pan feeders, and

(v) Retort equipment, including direct cooling and condensing equipment.

(i) [Reserved]

(j) *Natural gas from geopressured brine.* Equipment used exclusively to extract natural gas from geopressured brine described in section 613A(b)(3)(C)(i) is energy property.

Eligible equipment includes equipment used to separate the gas from saline water and remove other impurities from the gas. Equipment is eligible only up to the point the gas may be introduced into a pipeline.

(k) *Incremental cost.* The term "incremental cost" means the excess of the total cost of equipment over the amount that would have been expended for the equipment if the equipment were not used for a qualifying purpose. For example, assume equipment costing $100 performs a pollution control function and another function. Assuming it would cost $60 solely to perform the nonqualifying function, the incremental cost would be $40.

(l) *Existing*—(1) *In general.* for purposes of section 48(l), the term "existing" means—

(i) When used in connection with a facility or equipment, 50 percent or more of the basis of that facility or equipment is attributable to construction, reconstruction, or erection before October 1, 1978, or

(ii) When used in connection with an industrial or commercial process, that process was carried on in the facility as of October 1, 1978.

(2) *Industrial or commercial process.* (i) A process will be considered the same as the process carried on in the facility as of October 1, 1978, unless and until capitalizable expenditures are paid or incurred for modification of the process. The expenditures need not be capitalized in fact; it is sufficient if the taxpayer has an option or may elect to capitalize. In general, the date of change will be the date the expenditures are properly chargeable to capital account. If the taxpayer properly elects to expense a capitalizable expenditure, the date of change will be the date the expenditure could have been properly chargeable to capital account if the expenditure had been capitalized. Recapture will not occur by reason of a change in a process unless the process change also changes the use of the equipment. See example (1) of § 1.47-1(h)(5).

(m) *Quality and performance standards*—(1) *In general.* Energy property must meet quality and performance standards, if any, that have been prescribed by the Secretary (after consultation with the Secretary of Energy) and are in effect at the time of acquisition.

(2) *Time of acquisition.* Under this paragraph (m) the time of acquisition is—

(i) The date the taxpayer enters into a binding contract to acquire the property or

(ii) For property constructed, reconstructed, or erected by the traxpayer, (A) the earlier of the date it begins construction, reconstruction, or erection of the property, or (B) the date the taxpayer and another person enter into a binding contract requiring each to construct, reconstruct, or erect property and place the property in service for an agreed upon use. See example under paragraph (m)(4) of this section.

(3) *Binding contract.* Under this paragraph (m), a binding contract to construct, reconstruct, or erect property, or to acquire property, is a contract that is binding at all times on the taxpayer under applicable State or local law. A binding contract to construct, reconstruct, or erect property or to acquire property, does not include a contract for preparation of architect's sketches, blueprints, or performance of any other activity not involving the beginning of physical work.

(4) *Example.* The following example illustrates this paragraph (m).

Example. Corporation X owns a junk yard. Corporation Y manufactures recycling equipment and operates several recycling facilities. On January 1, 1979, X and Y enter into a written contract that is binding on both parties on that date and at all times thereafter. Under the contract's terms X will supply scrap metals to Y and Y agrees in return to build a recycling facility on land adjacent to the junk yard. Y will own and operate the facility using the scrap metal supplied by X. Y may treat the agreement as a binding contract under paragraph (m) (2) and (3) of this section.

(n) *Public utility property*—(1) *Inclusions.* Public utility property is included in both of the following categories of energy property:

(i) Shale oil equipment and

(ii) Equipment for producing natural gas from geopressured brine.

(2) *Exclusions.* Public utility property is excluded from each of the following categories of energy property:

(i) Alternative energy property,

(ii) Specially defined energy property,

(iii) Solar or wind energy property, and

(iv) Recycling equipment.

(3) *Public utility property.* The term "public utility property" has the meaning given in section 46(f)(5).

(Sec. 7805 (68A Stat. 917, 26 U.S.C. 7805) and 38 (b) (76 Stat. 962, 26 U.S.C. 38) of the Internal Revenue Code of 1954)

[T.D. 7291, 46 FR 7291, Jan. 23, 1981]

§ 1.50-1 Restoration of credit.

(a) *In general.* Section 49(a) (relating to termination of credit) does not apply to property—

(1) The construction, reconstruction, or erection of which by the taxpayer—

(i) Is completed after August 15, 1971, or

(ii) Is begun after March 31, 1971, or

(2) Which is acquired by the taxpayer—

(i) After August 15, 1971, or

(ii) After March 31, 1971, and before August 16, 1971, pursuant to an order which the taxpayer establishes was placed after March 31, 1971.

(b) *Transitional rule.* In the case of property (other than pretermination property) the construction, reconstruction, or erection of which by the taxpayer is begun before April 1, 1971, and completed after August 15, 1971, there shall be taken into account as the basis of new section 38 property in determining qualified investment only that portion of the basis which is properly attributable to construction, reconstruction, or erection after August 15, 1971.

(c) *Principles to be applied.* The principles of § 1.48-2 (b) and (c) shall be applied in determining when property is acquired and in determining that portion of the basis of property properly attributable to construction, reconstruction, or erection after August 15, 1971.

[T.D. 7203, 37 FR 17133, Aug. 25, 1972]

RULES FOR COMPUTING CREDIT FOR EXPENSES OF WORK INCENTIVE PROGRAMS

§ 1.50A-1 Determination of amount.

(a) *In general.* Except as otherwise provided in this section and in § 1.50A-2, the amount of the work incentive program (WIN) credit allowed by section 40 for the taxable year is equal to 20 percent of the taxpayer's WIN expenses (as determined under paragraph (a) of § 1.50B-1). The amount equal to 20 percent of the WIN expenses shall be referred to in this section and §§ 1.50A-2 through 1.50B-5 as the "credit earned."

(b) *Limitation based on amount of tax.* Notwithstanding the amount of the credit earned for the taxable year, under section 50A(a)(2) the credit allowed by section 40 for the taxable year is limited to—

(1) If the liability for tax (as defined in paragraph (c) of this section) is $25,000 or less, the liability for tax; or

(2) If the liability for tax is more than $25,000, then, the first $25,000 of the liability for tax plus 50 percent of the liability for tax in excess of $25,000. However, such $25,000 amount may be reduced in the case of certain married individuals filing separate returns (see paragraph (e) of this section); corporations which are members of a controlled group (see paragraph (f) of this section); estates and trusts (see paragraph (c) of § 1.50B-3); and organizations to which section 593 applies, regulated investment companies or real estate investment trusts subject to taxation under Subchapter M, Chapter 1 of the Code, and cooperative organizations described in section 1381(a) (see § 1.50B-5). The excess of the credit earned for the taxable year over the limitations described in this paragraph for such taxable year is an unused credit which may be carried back or forward to other taxable years in accordance with § 1.50A-2.

(c) *Liability for tax.* For the purpose of computing the limitation based on amount of tax, section 50A(a)(3) defines the liability for tax as the income tax imposed for the taxable year by Chapter 1 of the Code, re-

duced by the sum of the credits allowable under—

(1) Section 33 (relating to taxes of foreign countries and possessions of the United States,

(2) Section 37 (relating to credit for the elderly),

(3) Section 38 (relating to investment in certain depreciable property), and

(4) Section 41 (relating to contributions to candidates for public office).

For purposes of this paragraph, the tax imposed for the taxable year by section 56 (relating to imposition of minimum tax for tax preferences), section 72(m)(5)(B) (relating to 10 percent tax on premature distributions to owner-employees), section 402(e) (relating to tax on lump sum distributions), section 408(f) (relating to additional tax on income from certain retirement accounts), section 531 (relating to imposition of accumulated earnings tax), section 541 (relating to imposition of personal holding company tax), or section 1378 (relating to tax on certain capital gains of Subchapter S corporations), and any additional tax imposed for the taxable year by section 1351(d)(1) (relating to recoveries of foreign expropriation losses), shall not be considered tax imposed by Chapter 1 of the Code for such year. Thus, the liability for tax for purposes of computing the limitation based on amount of tax for the taxable year is determined without regard to any tax imposed by section 56, 72(m)(5)(B), 402(e), 408(f), 531, 541, 1351(d)(1) or 1378 of the Code. In addition, any increase in tax resulting from the application of section 50A (c) and (d) and § 1.50A-3 (relating to recomputation of credit allowed due to early termination of employment by employer, or failure to pay comparable wages) shall not be treated as tax imposed by Chapter 1 of the Code for purposes of computing the liability for tax. See section 50A (c)(3) and (d)(2).

(d) *Example.* The application of paragraphs (a), (b), and (c) of this section may be illustrated by the following example:

Example. X Corporation's WIN expenses for its taxable year ending December 31, 1973, are $500,000. X's credit earned for its taxable year is $100,000 (20 percent of $500,000). X's income tax for such year, computed without regard to credits against tax and without regard to any tax imposed by section 56, 531, 541, 1351(d)(1) or 1378, is $190,000. That amount includes $5,000 resulting from the application of section 50A(c)(3) and § 1.50 A-3. X is allowed under section 33 a foreign tax credit of $50,000. X's liability for tax is computed as follows:

Income tax (including increase in tax under section 50A(c)(3), but before any credits and without regard to any tax imposed by section 56, 531, 541, 1351(d)(1) or 1378)		$190,000
Less:		
Increase in tax resulting from application of section 50A(c)(3)	$5,000	
Foreign tax credit	50,000	
		55,000
Liability for tax		135,000

Under section 50A(a)(2) and paragraph (b) of this section, X's limitation based on amount of tax for the taxable year is $80,000 ($25,000 plus 50 percent of $110,000). X Corporation's credit allowed by section 40 for the taxable year therefore is $80,000. X has an unused credit for the year of $20,000 ($100,000 less $80,000) which it may carry back or forward to other taxable years in accordance with § 1.50A-2.

(e) *Married individuals.* If a separate return is filed by a husband or wife, the limitation based on amount of tax under paragraph (b) of this section shall be computed by substituting a $12,500 amount for the $25,000 amount in applying such paragraph (b). However, this reduction of the $25,000 amount to $12,500 applies only if the taxpayer's spouse is entitled to a credit under section 40 for the taxable year of such spouse which ends with, or within, the taxpayer's taxable year. The taxpayer's spouse is entitled to a credit under section 40 either because of incurring WIN expenses for such taxable year of the spouse (whether directly incurred by such spouse or whether apportioned to such spouse, for example, from an electing small business corporation, as defined in section 1371(b)), or because of a credit carryback or carryover to such taxable year under § 1.50A-2. The determination of whether an individual is married shall be made under the principles of section 143 and the regulations thereunder.

(f) *Apportionment of $25,000 amount among component members of a controlled group*—(1) *In general.* In determining the limitation based on amount of tax under section 50A(a)(2) in the case of corporations which are component members of a controlled group of corporations on a December 31, only one $25,000 amount is available to such component members for their taxable years that include such December 31. See subparagraph (2) of this paragraph for apportionment of such amount among such component members. See subparagraph (3) of this paragraph for the definition of "component member."

(2) *Manner of apportionment.* (i) In the case of corporations which are component members of a controlled group on a particular December 31, the $25,000 amount may be apportioned among such members for their taxable years that include such December 31 in any manner the component members may select, provided that each such member less than 100 percent of whose stock is owned, in the aggregate, by the other component members of the group on such December 31 consents to an apportionment plan. The consent of a component member to an apportionment plan with respect to a particular December 31 shall be made by means of a statement signed by a person duly authorized to act on behalf of the consenting member, stating that such member consents to the apportionment plan with respect to such December 31. The statement shall set forth the name, address, employer identification number, and taxable year of each component member of the group on such December 31, the amount apportioned to each such member under the plan, and the location of the Internal Revenue Service center where the statement is to be filed. The consent of more than one component member may be incorporated in a single statement. The statement shall be timely filed with the Internal Revenue Service center where the component member having the taxable year first ending on or after such December 31 files its return for such taxable year and shall be irrevocable after such filing. If two or more component members have the same such taxable year, a statement of consent may be filed by any one of such members. Such statement shall be considered as timely filed if filed on or before the due date (including any extensions of time) of such member's income tax return which includes such December 31. However, if the due date (including any extensions of time) of the return of such member is on or before December 15, 1972, the required statement shall be considered as timely filed if filed on or before March 15, 1973. Each component member of the group on such December 31 shall keep as a part of its records a copy of the statement containing all the required consents.

(ii) An apportionment plan adopted by a controlled group with respect to a particular December 31 shall be valid only for the taxable year of each member of the group which includes such December 31. Thus, a controlled group must file a separate consent to an apportionment plan with respect to each taxable year which includes a December 31 as to which an apportionment plan is desired.

(iii) If an apportionment plan is not timely filed, the $25,000 amount specified in section 50A(a)(2) shall be reduced for each component member of the controlled group, for its taxable year which includes a December 31, to an amount equal to $25,000 divided by the number of component members of each group on such December 31.

(iv) If a component member of the controlled group makes its income tax return on the basis of a 52-53 week taxable year, the principles of section 441(f)(2)(A)(ii) and paragraph (b)(1) of § 1.441-2 apply in determining the last day of such taxable year.

(3) *Definitions of controlled group of corporations and component member of controlled group.* For the purpose of this paragraph, the terms "controlled group of corporations" and "component member" of a controlled group of corporations shall have the same meaning assigned to those terms in section 1563 (a) and (b) and the regulations thereunder. For purposes of applying § 1.1563-1(b)(2)(ii)(c), an electing small business corporation shall be treated as an excluded

member whether or not it is subject to the tax imposed by section 1378.

(4) *Members of a controlled group filing a consolidated return.* If some component members of a controlled group join in filing a consolidated return pursuant to § 1.1502-3(a)(3), and other component members do not join, then, unless a consent is timely filed apportioning the $25,000 amount among the group filing the consolidated return and the other component members of the controlled group, each component member of the controlled group (including each component member which joins in filing the consolidated return) shall be treated as a separate corporation for purposes of equally apportioning the $25,000 amount under subparagraph (2)(iii) of this paragraph. In such case, the limitation based on the amount of tax for the group filing the consolidated return shall be computed by substituting for the $25,000 amount the total of the amount apportioned to each component member which joins in filing the consolidated return. If the affiliated group, filing the consolidated return and the other component members of the controlled group adopt an apportionment plan, the affiliated group shall be treated as a single member for the purpose of applying subparagraph (2)(i) of this paragraph. Thus, for example, only one consent executed by the common parent to the apportionment plan is required for the group filing the consolidated return. If any component member of the controlled group which joins in the filing of the consolidated return is an organization to which section 593 applies or a cooperative organization described in section 1381(a), rules similar to the rules contained in paragraph (a)(3)(ii) of § 1.1502-3 are applicable.

(5) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). At all times during 1972 Smith, an individual, owns all the stock of corporations X, Y, and Z. Corporation X files an income tax return on a calendar year basis. Corporation Y files an income tax return on the basis of a fiscal year ending June 30. Corporation Z files an income tax return on the basis of a fiscal year ending September 30. On December 31, 1972, X, Y, and Z are component members of the same controlled group. X, Y, and Z all consent to an apportionment plan in which the $25,000 amount is apportioned entirely to Y for its taxable year ending June 30, 1973 (Y's taxable year which includes December 31, 1972). Such consent is timely filed. For purposes of computing the credit under section 40, Y's limitation based on amount of tax for its taxable year ending June 30, 1973, is so much of Y's liability for tax as does not exceed $25,000, plus 50 percent of Y's liability for tax in excess of $25,000. X's and Z's limitations for their taxable years ending December 31, 1972, and September 30, 1973, respectively, are equal to 50 percent of X's liability for tax and 50 percent of Z's liability for tax. On the other hand, if an apportionment plan is not timely filed, X's limitation would be so much of X's liability for tax as does not exceed $8,333.33, plus 50 percent of X's liability in excess of $8,333.33, and Y's and Z's limitations would be computed similarly.

Example (2). At all times during 1972, Jones, an individual, owns all the outstanding stock of corporations P, Q, and R. Corporations Q and R both file returns for taxable year ending December 31, 1972. P files a consolidated return as a common parent for its fiscal year ending June 30, 1973, with its wholly owned subsidiaries N and O. On December 31, 1972, N, O, P, Q, and R are component members of the same controlled group. No consent to an apportionment plan is filed. Therefore, each member is apportioned $5,000 of the $25,000 amount ($25,000 divided equally among the five members). The limitation based on the amount of tax for the group filing the consolidated return (P, N, and O) for the year ending June 30, 1973 (the consolidated taxable year within which December 31, 1972, falls), is computed by using $15,000 instead of the $25,000 amount. The $15,000 is arrived at by adding together the $5,000 amounts apportioned to P, N, and O.

[38 FR 6152, Mar. 7, 1973, as amended by T.D. 7636, 44 FR 47049, Aug. 10, 1979]

§ 1.50A-2 Carryback and carryover of unused credit.

(a) *Allowance of unused credit as carryback or carryover*—(1) *In general.* Section 50A(b)(1) provides for carrybacks and carryovers of any unused credit. An unused credit is the excess of the credit earned for the taxable year (as determined under paragraph (a) of § 1.50A-1) over the limitation based on amount of tax for such taxable year (as determined under paragraph (b) of § 1.50A-1). Subject to the limitation contained in paragraph (b)

of this section, an unused credit shall be added to the amount allowable as a credit under section 40 for the years to which the unused credit can be carried. The year with respect to which an unused credit arises shall be referred to in this section as the "unused credit year."

(2) *Taxable years to which unused credit may be carried.* An unused credit shall be a work incentive program (WIN) credit carryback to each of the 3 taxable years preceding the unused credit year and a WIN credit carryover to each of the 7 taxable years succeeding the unused credit year, except that an unused credit shall be a carryback only to taxable years beginning after December 31, 1971. An unused credit must be carried first to the earliest of the taxable years to which it may be carried, and then to each of the other taxable years (in order of time) to the extent that the unused credit may not be added (because of the limitation contained in paragraph (b) of this section) to the amount allowable as a credit under section 40 for a prior taxable year.

(b) *Limitation on allowance of unused credit.* The amount of the unused credit from any particular unused credit year which may be added to the amount allowable as a credit under section 40 for any of the preceding or succeeding taxable years to which such credit may be carried shall not exceed the amount by which the limitation based on amount of tax for such preceding or succeeding taxable year exceeds the sum of (1) the credit earned for such preceding or succeeding year, and (2) other unused credits carried to such preceding or succeeding year which are attributable to unused credit years prior to the particular unused credit year.

(c) *Corporate acquisitions.* For the carryover of unused credits in the case of certain corporate acquisitions, see section 381(c)(24) and the regulations thereunder. [§ 1.381(c)(24)-1]

(d) *Periods of less than 12 months.* A fractional part of a year which is considered as a taxable year under sections 441(b) and 7701(a)(23) shall be treated as a preceding or a succeeding taxable year for the purpose of determining under section 50A(b) and this section the taxable years to which an unused credit may be carried.

(e) *Example.* The provisions of paragraphs (a) through (d) of this section may be illustrated by the following example:

Example. Corporation X files its income tax return on the basis of the calendar year. X's credit earned and its limitation based on amount of tax for each of its taxable years 1972 through 1978 are as follows:

	Credit earned	Limitation based on amount of tax
1972	$175,000	$200,000
1973	250,000	160,000
1974	200,000	210,000
1975	210,000	230,000
1976	220,000	260,000
1977	260,000	220,000
1978	270,000	280,000

(i) Corporation X's credit earned for 1972, $175,000, is allowable in full as a credit under section 40 for 1972 since such amount is less than the limitation based on amount of tax for such year, $200,000. Since the limitation based on amount of tax for 1973 is $160,000, only $160,000 of the $250,000 credit earned for such year is allowable under section 40 as a credit for 1973. The unused credit for 1973 of $90,000 ($250,000 less $160,000) is a WIN credit carryback to 1972 and a WIN credit carryover to 1974 and subsequent years up to and including 1980. The portion of the $90,000 unused credit which shall be added to the amount allowable as a credit under section 40 for 1972 and 1974 and subsequent years is computed as follows:

(*a*) *1972.* The portion of the unused credit for 1973 ($90,000) which is allowable as a credit for 1972 is $25,000. This amount shall be added to the amount allowable as a credit for 1972. The balance of the unused credit for 1973 to be carried to 1974 is $65,000. These amounts are computed as follows:

Carryback to 1972			$90,000
1972 limitation based on tax		$200,000	
Less: Credit earned for 1972	$175,000		
Unused credits attributable to years preceding 1973	0		
		175,000	
Limit on amount of 1973 unused credit which may be added as a credit for 1972			25,000
Balance of 1973 unused credit to be carried to 1974			65,000

(*b*) *1974.* The portion of the balance of the unused credit for 1973 ($65,000) allowable as a credit for 1974 is $10,000. This amount shall be added to the amount allowable as a credit for 1974. The balance of the unused credit for 1973 to be carried to 1975 is $55,000. These amounts are computed as follows:

Carryover to 1974			$65,000
1974 limitation based on tax		$210,000	
Less: Credit earned for 1974	$200,000		
Unused credits attributable to years preceding 1973	0	200,000	
Limit on amount of 1973 unused credit which may be added as a credit for 1974			10,000
Balance of 1973 unused credit to be carried to 1975			55,000

(*c*) *1975.* The portion of the balance of the unused credit for 1973 ($55,000) allowable as a credit for 1975 is $20,000. This amount shall be added to the amount allowable as a credit for 1975. The balance of the unused credit for 1973 to be carried to 1976 is $35,000. These amounts are computed as follows:

Carryover to 1975			$55,000
1975 limitation based on tax		$230,000	
Less: Credit earned for 1975	$210,000		
Unused credits attributable to years preceding 1973	0	210,000	
Limit on amount of 1973 unused credit which may be added as a credit for 1975			$20,000
Balance of 1973 unused credit to be carried to 1976			35,000

(*d*) *1976.* The entire balance of the unused credit for 1973 ($35,000) is allowable as a credit for 1976, since the limitation based on amount of tax for 1976 exceeds the sum of the credit earned for 1976 and unused credits attributable to years prior to 1973 by an amount in excess of $35,000. Since the balance of the unused credit for 1973 has been fully allowed, no portion thereof remains to be carried to subsequent taxable years. This is illustrated as follows:

Carryover to 1976			$35,000
1976 limitation based on tax		$260,000	
Less: Credit earned for 1976	$220,000		
Unused credits attributable to years preceding 1973	0	220,000	
Limit on amount of 1973 unused credit which may be added as a credit for 1976			40,000
Balance of 1973 unused credit to be carried to 1977			0

(ii) Since the limitation based on amount of tax for 1977 is $220,000, only $220,000 of the $260,000 credit earned for such year is allowable as a credit for 1977. The unused credit for 1977 of $40,000 ($260,000 less $220,000) is a WIN credit carryback to 1974, 1975, and 1976 and a WIN credit carryover to 1978 and subsequent years. The portions of the $40,000 unused credit which shall be added to the amount allowable as a credit for such years are computed as follows:

(*a*) *1974.* The portion of the unused credit for 1977 ($40,000) allowable as a credit for 1974 is zero. The balance of the unused credit for 1977 to be carried to 1975 is $40,000. These amounts are computed as follows:

Carryback to 1974			$40,000
1974 limitation based on tax		$210,000	
Less: Credit earned for 1974	$200,000		
Unused credits attributable to years preceding 1977 (unused credit from 1973)	10,000	$210,000	
Limit on amount of 1977 unused credit which may be added as a credit for 1974			0
Balance of 1977 unused credit to be carried to 1975			40,000

(*b*) *1975.* The portion of the unused credit for 1977 ($40,000) allowable as a credit for 1975 is zero. The balance of the unused credit for 1977 to be carried to 1976 is $40,000. These amounts are computed as follows:

Carryback to 1975			$40,000
1975 limitation based on tax		$230,000	
Less: Credit earned for 1975	$210,000		
Unused credits attributable to years preceding 1977 (unused credit from 1973)	20,000	230,000	
Limit on amount of 1977 unused credit which may be added as a credit for 1975			0
Balance of 1977 unused credit to be carried to 1976			40,000

(*c*) *1976.* The portion of the unused credit for 1977 ($40,000) allowable as a credit for 1976 is $5,000. This amount shall be added to the amount allowable as a credit for 1976. The balance of the unused credit for 1977 to be carried to 1978 is $35,000. These amounts are computed as follows:

Carryback to 1976			$40,000
1976 limitation based on tax		$260,000	

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Less: Credit earned for 1976	$220.000	
Unused credits attributable to years preceding 1977 (unused credit from 1973)	35.000	255.000
Limit on amount of 1977 unused credit which may be added as a credit for 1976		5.000
Balance of 1977 unused credit to be carried to 1978		35.000

(*d*) *1978.* The portion of the balance of the unused credit for 1977 ($35,000) allowable as a credit for 1978 is $10,000. This amount shall be added to the amount allowable as a credit for 1978. The balance of the unused credit for 1977 to be carried to 1979 and subsequent years is $25,000. These amounts are computed as follows:

Carryover to 1978		$35.000
1978 limitation based on tax	$280.000	
Less: Credit earned for 1978	$270.000	
Unused credits attributable to years preceding 1977	0	$270.000
Limit on amount of 1977 unused credit which may be added as a credit for 1978		$10.000
Balance of 1977 unused credit to be carried to 1979		25.000

(f) *Electing small business corporation.* An unused credit of a corporation which arises in an unused credit year for which the corporation is not an electing small business corporation (as defined in section 1371(b)) and which is a carryback or carryover to a taxable year for which the corporation is an electing small business corporation shall not be added to the amount allowable as a credit under section 40 to the shareholders of such corporation for any taxable year. However, a taxable year for which the corporation is an electing small business corporation shall be counted as a taxable year for purposes of determining the taxable years to which such unused credit may be carried.

[38 FR 6153, Mar. 7, 1973]

§ 1.50A-3 Recomputation of credit allowed by section 40.

(a) *General rule*—(1) *Early termination of employment by employer*—(i) *In general.* If the employment of any employee, with respect to whom work incentive program (WIN) expenses (as defined in paragraph (a) of § 1.50B-1) are taken into account under paragraph (a) of § 1.50A-1, is terminated by the taxpayer at any time during the first 12 months of such employment (whether or not consecutive) or before the close of the 12th calendar month after the calendar month in which such employee completes the first 12 months of employment (whether or not consecutive) with the taxpayer, then subparagraph (3) of this paragraph shall apply. See paragraph (c) of this section for rules relating to the determination of the first 12 months of employment (whether or not consecutive). See § 1.50A-4 for rules relating to other circumstances under which a termination of employment will not be treated as a termination of employment to which the provisions of subparagraph (3) of this paragraph are applicable.

(ii) *Rules for determining whether a termination of employment has occurred.* For purposes of this section, the taxpayer is deemed to have terminated the employment of any WIN employee (as defined in paragraph (h) of § 1.50B-1) if the employment relationship (as determined under common law principles) has terminated. A layoff for any reason is considered a termination of employment for purposes of the preceding sentence. However, a temporary suspension of employment of any WIN employee necessitated by the installation of new equipment or by the retooling of existing equipment (such as for a model changeover in the automobile industry) shall not be deemed to be a termination of employment if such suspension is for a period of time no longer than 60 days. For purposes of this section, the death of the taxpayer is considered a termination of the employment relationship between the taxpayer and any WIN employee.

(2) *Failure to pay comparable wages*—(i) *In general.* If, at any time during the period described in subparagraph (1)(i) of this paragraph, the taxpayer pays wages (as defined in section 50B(b) and paragraph (b) of § 1.50B-1) to an employee, with respect to whom WIN expenses are taken into account under paragraph (a) of § 1.50A-1, which are less than the wages paid to other employees of the taxpayer who perform comparable

services, then subparagraph (3) of this paragraph shall apply.

(ii) *Comparable services.* (*a*) For purposes of subdivision (i) of this subparagraph, the term "comparable services" refers to services performed in work positions which require similar education, training, and skills. Comparable services are those associated with other work positions which require similar levels of judgment and responsibility, which make similar physical and mental demands of an employee, and which could easily be performed by the employee without substantial additional training or experience.

(*b*) If substantial training, skill, or experience are material to the performance of a particular job, a taxpayer may pay wages to a WIN employee which are less than those paid to other employees of the taxpayer who possess such training, skill, or experience. However, there must be a reasonable relationship between the lower wages or salary of such WIN employee and his relative lack of training, skill, or experience.

(3) *Recomputation of credit earned.* (i) If, by reason of subparagraph (1) or (2) of this paragraph, this subparagraph (3) is applicable, then the credit earned for all credit years (as defined in subdivision (ii) (*a*) of this subparagraph) shall be recomputed under the principles of paragraph (a) of § 1.50A-1 by not taking into account WIN expenses with respect to the employee (or employees) described in subparagraph (1) or (2) of this paragraph. There shall be recomputed under the principles of §§ 1.50A-1 and 1.50A-2 the credit allowed for all credit years and for any other taxable year affected by reason of the reduction in credit earned for such credit year or years, giving effect to such reduction in the computation of carrybacks or carryovers of unused credit from any taxable year. If the recomputation described in the preceding sentence results, in the aggregate, in a decrease (taking into account any recomputation under this paragraph in respect of prior recapture years, as defined in subdivision (ii) (*b*) of this subparagraph) in the credits allowed for any credit year and for any other taxable year affected by the reduction in credit earned for any credit year, then the income tax for the recapture year shall be increased by the amount of such decrease in credits allowed. For treatment of such increase in tax, see paragraph (b) of this section. For special rules in the case of an electing small business corporation (as defined in section 1371(b)), an estate or trust, or a partnership, see respectively, § 1.50A-5, § 1.50A-6 or § 1.50A-7.

(ii) For purposes of this section and §§ 1.50A-4 through 1.50B-6—

(*a*) The term "credit year" means a taxable year in which WIN expenses with respect to the employee described in subparagraph (1) or (2) of this paragraph are taken into account under paragraph (a) of § 1.50A-1.

(*b*) The term "recapture year" means a taxable year in which a termination of employment (within the meaning of subparagraph (1) of this paragraph) or a failure to pay comparable wages (within the meaning of subparagraph (2) of this paragraph) occurs by reason of which the rule of subparagraph (3) of this paragraph becomes applicable.

(*c*) The term "recapture determination" means a recomputation made under this paragraph.

(b) *Increase in income tax and reduction of WIN credit carryback and carryover*—(1) *Increase in tax.* Except as provided in subparagraph (2) of this paragraph, any increase in income tax under this section shall be treated as income tax imposed on the taxpayer by Chapter 1 of the Code for the recapture year notwithstanding that without regard to such increase the taxpayer has no income tax liability, has a net operating loss for such taxable year, or no income tax return was otherwise required for such taxable year.

(2) *Special rule.* Any increase in income tax under this section shall not be treated as income tax imposed on the taxpayer by Chapter 1 of the Code for purposes of determining the amount of the credits allowable to such taxpayer under—

(i) Section 33 (relating to taxes of foreign countries and possessions of the United States),

(ii) Section 35 (relating to partially tax-exempt interest received by individuals),

(iii) Section 37 (relating to retirement income),

(iv) Section 38 (relating to investment in certain depreciable property),

(v) Section 39 (relating to certain uses of gasoline, special fuels, and lubricating oil),

(vi) Section 40 (relating to expenses of work incentive programs), and

(vii) Section 41 (relating to contributions to candidates for public office).

(3) *Reduction in credit allowed as a result of a net operating loss carryback.* (i) If a net operating loss carryback from the recapture year or from any taxable year subsequent to the recapture year reduces the amount allowed as a credit under section 40 for any taxable year up to and including the recapture year, then there shall be a new recapture determination under paragraph (a) of this section for each recapture year affected, taking into account the reduced amount of credit allowed after application of the net operating loss carryback.

(ii) Subdivision (i) of this subparagraph may be illustrated by the following example:

Example. (a) X Corporation, which makes its returns on the basis of a calendar year, hired WIN employees on March 1, 1972, and incurred $10,000 in WIN expenses with respect to these employees for the year. For the taxable year 1972, X Corporation's credit earned of $2,000 (20 percent of $10,000) was allowed under section 40 as a credit against its liability for tax of $2,000. In 1973 and 1974 X Corporation had no liability for tax and had no WIN expenses. In January 1974, X Corporation terminated the employees for whom the WIN expenses had been incurred. Since these terminations were not subject to the exceptions provided by § 1.50A-4, there was a recapture determination under paragraph (a) of this section. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1974 was increased by the $2,000 decrease in its credit earned for the taxable year 1972 (that is, the $2,000 original credit earned minus zero recomputed credit earned).

(b) For the taxable year 1975, X Corporation has a net operating loss which is carried back to the taxable year 1972 and reduces its liability for tax, as defined in paragraph (c) of § 1.50A-1, for such taxable year to $800. As a result of such net operating loss carryback, X Corporation's credit allowed under section 40 for the taxable year 1972 is limited to $800 and the excess of $1,200 ($2,000 credit earned minus the $800 limitation based on amount of tax) is a WIN credit carryover to the taxable year 1973.

(c) For 1975 there is a recapture determination under subdivision (i) of this subparagraph for the 1974 recapture year. The $2,000 increase in the income tax imposed on X Corporation for the taxable year 1974 is redetermined to be $800 (that is, the $800 credit allowed after taking into account the 1975 net operating loss minus zero credit which would have been allowed taking into account the 1974 recapture determination). In addition, X Corporation's $1,200 WIN credit carryover to the taxable year 1973 is reduced by $1,200 ($2,000 minus $800) to zero and X Corporation is entitled to a $1,200 refund of the $2,000 tax paid as a result of the 1974 recapture determination.

(4) *Statement of recomputation.* The taxpayer shall attach to his income tax return for the recapture year a separate statement showing in detail the computation of the increase in income tax imposed on such taxpayer by Chapter 1 of the Code and the reduction in any WIN credit carryovers.

(c) *Period of employment*—(1) *Initial date of employment.* For purposes of this section and §§ 1.50A-4 through 1.50B-6, the initial date of employment (for purposes of applying paragraph (a) (1) and (2) of this section and paragraphs (a)(1) and (f) of § 1.50B-1) is the date the WIN employee reports to the taxpayer (or in the case where the taxpayer is a partner of a partnership, a beneficiary of an estate or trust, or a shareholder of an electing small business corporation, to such partnership, estate, trust, or electing small business corporation) for work.

(2) *Computation of the first 12 months of employment (whether or not consecutive).* For purposes of computing the first 12 months of employment (whether or not consecutive), the first month of employment shall begin with the initial date of employment (as defined in subparagraph (1) of this paragraph) of the WIN employee, the second month of employment shall begin with the corresponding date in the following month, the third month of employment shall begin with the corresponding date in the next following month, and so forth. If the WIN

employee performs any services during any such month (as determined under the preceding sentence), that month shall be counted in computing the WIN employee's "first 12 months of employment (whether or not consecutive)". If the WIN employee performs no services during any such month, that month shall not be counted in computing the WIN employee's "first 12 months of employment (whether or not consecutive)". Thus, if the initial date of employment of a WIN employee is June 15, the first month of employment of such employee shall be the period beginning June 15, and ending July 14. The second month of employment is the period beginning July 15 and ending August 14. If during such second month of employment the employee performs no services for the taxpayer, that month is not counted in determining the employee's first 12 months of employment (whether or not consecutive).

[38 FR 6154, Mar. 7, 1973]

§ 1.50A-4 Exceptions to the application of § 1.50A-3.

(a) *In general.* Notwithstanding the provisions of paragraph (a) of § 1.50A-3, a termination of employment shall not be deemed to occur if paragraph (b) (relating to voluntary termination of employment), paragraph (c) (relating to termination of employment due to disability), paragraph (d) (relating to termination of employment due to misconduct), paragraph (f) (relating to transactions to which section 381(a) applies), or paragraph (g) (relating to mere change in form of conducting a trade or business) applies.

(b) *Voluntary termination of employment.* A termination of employment shall not be deemed to occur for purposes of paragraph (a) of § 1.50A-3 if the employee voluntarily leaves the employment of the taxpayer. If the taxpayer makes the working conditions of the employee so untenable that the employee is, in effect, compelled by the taxpayer to quit, or if the employee is coerced into quitting, the employee will not be deemed to have voluntarily left the employment of the taxpayer. For purposes of the preceding sentence, a substantial reduction in the benefits of employment of an employee (such as a substantial decrease in the hours of the employee's working week) shall constitute untenable working conditions. An employee has voluntarily left the employment of the taxpayer if he leaves for any reason external to his employment, such as sickness or death in the employee's family which the employee feels necessitates his quitting work with the taxpayer to remain at home. Any employee who participates in an authorized strike (as finally determined by a court, labor relations administrative body, or arbiter) will not be deemed to have voluntarily left the employment of the taxpayer.

(c) *Termination of employment due to death or disability.* A termination of employment shall not be deemed to occur for purposes of paragraph (a) of § 1.50A-3 if, after the initial date of employment (as defined in paragraph (c)(1) of § 1.50A-3) and before the close of the period referred to in paragraph (a)(1) of § 1.50A-3, the employee becomes disabled, by reason of illness or injury (including a disability relating to the employment), to perform the services required by such employment, unless, before the close of such period:

(1) Such disability is removed,

(2) The employer knows of the removal of the disability, and

(3) The employer fails to offer reemployment to such employee.

The death of an employee shall not be deemed a termination of employment for purposes of paragraph (a) of § 1.50A-3.

(d) *Termination of employment due to misconduct.* A termination of employment shall not be deemed to occur for purposes of paragraph (a) of § 1.50A-3 if it is determined by the appropriate State administrative agency or State court that under the applicable State unemployment compensation law such termination was due to the misconduct of the WIN employee. If the WIN employee is not covered by the applicable State unemployment compensation law (or if the employee did not work for the minimum period required to qualify for unemployment compensation or if the employee did not apply for unemployment compen-

sation), a termination of employment shall not be deemed to occur for purposes of paragraph (a) of § 1.50A-3 if the taxpayer demonstrates by convincing evidence that, were such employee covered by the applicable State unemployment compensation law (or if the employee had worked for such minimum period or if the employee had applied for unemployment compensation), he could reasonably have been found by such administrative agency or court to have been terminated for misconduct.

(e) *Recordkeeping requirement.* A taxpayer who is claiming that a termination of employment falls within the provisions of paragraph (b), (c), or (d) of this section shall maintain sufficient records to support his claim until the expiration of the pertinent period of limitations.

(f) *Transactions to which section 381(a) applies*—(1) *General rule.* The employment relationship between the taxpayer and a WIN employee (as defined in paragraph (h) of § 1.50B-1) shall not be deemed terminated for purposes of paragraph (a) of § 1.50A-3 in the case of a transaction to which section 381(a) (relating to carryovers in certain corporate acquisitions) applies. If there is a termination of employment (within the meaning of paragraph (a) of § 1.50A-3 and this section) by the acquiring corporation with respect to the WIN employee described in the preceding sentence, or if the acquiring corporation fails to pay comparable wages to such employee (within the meaning of paragraph (a)(2) of § 1.50A-3), then paragraph (a)(3) of § 1.50A-3 shall apply to the acquiring corporation with respect to the credit allowed the acquired corporation as well as the credit allowed the acquiring corporation with respect to such employee. For purposes of the preceding sentence, the initial date of employment (as defined in paragraph (c)(1) of § 1.50A-3) of such employee with respect to the acquired corporation shall be deemed to be the initial date of employment of such employee with respect to the acquiring corporation and employment by the acquired corporation shall be deemed employment by the acquiring corporation.

(2) *Examples.* This paragraph may be illustrated by the following examples:

Example (1). (i) X Corporation, a wholly owned subsidiary of Y Corporation, incurred WIN expenses of $12,000 for its taxable year ending December 31, 1972, with respect to WIN employees hired on March 1, 1972. Both X and Y made their returns on the basis of a calendar year. For the taxable year 1972 X Corporation's credit earned of $2,400 (20 percent of $12,000) was allowed under section 40 as a credit against its liability for tax. On December 15, 1973, X Corporation is liquidated under section 332 and all of its assets and liabilities are transferred to Y Corporation in a transaction to which section 334(b)(2) is not applicable. In addition, Y Corporation continues the employment of the WIN employees which were employed by X Corporation and with respect to which X Corporation was allowed the credit for its taxable year 1972.

(ii) Under subparagraph (1) of this paragraph, a termination of employment of the WIN employees shall not be deemed to occur for purposes of paragraph (a)(1) of § 1.50A-3 due to the liquidation of X Corporation on December 15, 1973. Thus, no recapture determination under paragraph (a)(3) of § 1.50A-3 shall be made with respect to X Corporation.

Example (2). (i) The facts are the same as in Example (1) and, in addition, on February 2, 1974, Y Corporation terminates the employment of the employees with respect to whom X Corporation had incurred WIN expenses. The termination is a termination for purposes of paragraph (a)(1) of § 1.50A-3. For purposes of applying the period described in paragraph (a)(1) of § 1.50A-3, the date the employees reported for work at X Corporation is deemed to be the initial date of employment of the employees with respect to Y Corporation.

(ii) Under subparagraph (1) of this paragraph, a termination of employment of the WIN employees shall not be deemed to occur for purposes of paragraph (a)(1) of § 1.50A-3 due to the liquidation of X Corporation on December 15, 1973. However, a termination of employment of the WIN employees is deemed to occur for purposes of paragraph (a)(1) of § 1.50A-3 on February 2, 1974. Thus, Y Corporation shall make a recapture determination under paragraph (a) of § 1.50A-3 with respect to the credit allowed X Corporation with respect to the WIN employees.

(g) *Mere change in form of conducting a trade or business*—(1) *General rule.* (i) The employment relationship between the taxpayer and a WIN employee (as defined in paragraph (h) of

§ 1.50B-1) shall not be deemed terminated for purposes of paragraph (a) of § 1.50A-3 in the case of a mere change in the form of conducting the trade or business in which such employment occurs, provided that the conditions set forth in subdivision (ii) of this subparagraph are satisfied.

(ii) The conditions referred to in subdivision (i) of this subparagraph are as follows:

(*a*) The WIN employee described in subdivision (i) of this subparagraph is retained in the same trade or business,

(*b*) The taxpayer retains a substantial ownership interest in such trade or business,

(*c*) Substantially all the assets necessary to operate such trade or business are transferred to the transferee who continues the employment of the WIN employee described in subdivision (i) of this subparagraph, and

(*d*) The basis of the assets described in (*c*) of this subdivision in the hands of the transferee is determined in whole or in part by reference to the basis of such assets in the hands of the transferor.

This subparagraph shall not apply if paragraph (e) of this section (relating to transactions to which section 381(a) applies) is applicable with respect to such transfer.

(2) *Substantial interest.* For purposes of this paragraph, the taxpayer shall be considered as having retained a substantial ownership interest in the trade or business only if, after the change in form, the ownership interest in such trade or business by such taxpayer—

(i) Is substantial in relation to the total ownership interests of all persons, or

(ii) Is equal to or greater than the ownership interest prior to the change in form.

Thus, where a taxpayer owns a 5-percent interest in a partnership, and, after the incorporation of that partnership, the taxpayer retains at least a 5-percent interest in the corporation, the taxpayer will be considered as having retained a substantial interest in the trade or business as of the date of the change in form because of the application of the rule contained in subdivision (ii) of this subparagraph.

(3) *Termination of employment.* (i) If employment of a WIN employee described in subparagraph (1)(i) of this paragraph is terminated by the transferee, the employment of such employee shall be deemed terminated by the taxpayer for purposes of paragraph (a) of § 1.50A-3. For purposes of determining the period described in paragraph (a)(1) of § 1.50A-3 with respect to such taxpayer employment by the transferee shall be deemed employment by the transferor.

(ii) If in any taxable year the taxpayer does not retain a substantial ownership interest in the trade or business directly or indirectly (through ownership in other entities provided that such other entities' bases in such interest are determined in whole or in part by reference to the basis of such interest in the hands of the taxpayer) then, for purposes of paragraph (a)(1) of § 1.50A-3, there shall be deemed to be a termination of employment of the WIN employees described in subparagraph (1)(i) of this paragraph on the first date on which such taxpayer does not retain a substantial interest in the trade or business. For purposes of determining the period described in paragraph (a)(1) of § 1.50A-3, employment by the transferee shall be deemed employment by the transferor. Any taxpayer who seeks to establish his interest in a trade or business under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in such trade or business after any such transfer or transfers.

(iii) Notwithstanding subparagraph (1) of this paragraph and subdivision (ii) of this subparagraph in the case of a mere change in the form of a trade or business, if the interest of a taxpayer in the trade or business is reduced but such taxpayer has retained a substantial interest in such trade or business, paragraph (a)(2) of § 1.50A-5 (relating to electing small business corporations), paragraph (a)(2) of § 1.50A-6 (relating to estates or trusts), or paragraph (a)(2)(ii) of § 1.50A-7 (relating to partnerships) shall apply, as the case may be.

(4) *Failure to pay comparable wages.* If the transferee fails to pay comparable wages (within the meaning of paragraph (a)(2) of § 1.50A-3) to the WIN employee within the period described in paragraph (a)(1) of § 1.50A-3, then such failure shall be deemed to be a failure of the transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the partners, beneficiaries, or shareholders), and a recapture determination shall be made with respect to such WIN employee as provided in § 1.50A-3. For purposes of determining the period described in paragraph (a)(1) of § 1.50A-3 with respect to such transferor (or such partners, beneficiaries, or shareholders), employment by the transferee shall be deemed employment by such transferor. For special rules in the case of an electing small business corporation (as defined in section 1371(b)), an estate or trust, or a partnership, see respectively, § 1.50A-5, § 1.50A-6, or § 1.50A-7.

(5) *Examples.* This paragraph may be illustrated by the following examples in each of which it is assumed that the transfer satisfies the conditions of subparagraph (1)(ii) (*a*), (*c*) and (*d*) of this paragraph.

Example (1). (i) On January 1, 1972, A, an individual, employed WIN employees in his sole proprietorship. A incurred WIN expenses with respect to these employees of $12,000 for the taxable year ending December 31, 1972. For the taxable year 1972 A's credit earned of $2,400 (20 percent of $12,000) was allowed under section 40 as a credit against his liability for tax. On March 15, 1973, A transferred all of the assets used in his sole proprietorship to X Corporation, a newly formed corporation, in exchange for 45 percent of the stock of X Corporation.

(i) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.50A-3 does not apply to the March 15, 1973, transfer to X Corporation.

Example (2). (i) The facts are the same as in Example (1) and in addition on June 1, 1973, X Corporation terminates the employment of WIN employees with respect to whom 50 percent of the WIN expenses were incurred during A's 1972 taxable year.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.50A-3 does not apply to the March 15, 1973, transfer to X Corporation. However, under subparagraph (3)(i) of this paragraph, paragraph (a) of § 1.50A-3 applies to the June 1, 1973, termination of WIN employees by X Corporation. The actual period of employment of such WIN employees is 1 year and 5 months (that is, the period beginning on January 1, 1972, and ending on June 1, 1973). For taxable year 1972, A's recomputed credit earned is $1,200 (20 percent of $6,000). The income tax imposed by Chapter 1 of the Code on A for the taxable year 1973 is increased by the $1,200 decrease in his credit earned for the taxable year 1972 (that is, $2,400 original credit earned minus $1,200 recomputed credit earned).

Example (3). (i) The facts are the same as in Example (1) and in addition on April 1, 1973, X Corporation begins paying wages to the employees referred to in Example (1) which are less than the wages paid to its other employees who perform comparable services.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a)(1) of § 1.50A-3 does not apply to the March 15, 1973, transfer to X Corporation. However, under subparagraph (4) of this paragraph, paragraph (a) of § 1.50A-3 applies to the failure of X Corporation to pay wages to the WIN employees which are equal to the wages paid to its other employees who perform comparable services. For taxable year 1972, A's recomputed credit earned is zero. The income tax imposed by Chapter 1 of the Code on A for the taxable year 1973 is increased by the $2,400 decrease in his credit earned for the taxable year 1972.

Example (4). (i) On January 1, 1972, partnership ABC, which makes its returns on the basis of a calendar year, employed WIN employees. Partnership ABC incurred WIN expenses with respect to these employees of $20,000 for the taxable year. Partnership ABC has 10 partners who make their returns on the basis of a calendar year and share partnership profits equally. Each partner's share of the WIN expenses is 10 percent, that is, $2,000. On March 15, 1973, partnership ABC transfers all of the assets used in its trade or business to the X Corporation, a newly formed corporation, in exchange for its stock and immediately thereafter transfers 10 percent of the stock to each of the 10 partners.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a)(1) of § 1.50A-1 does not apply to the March 15, 1973, transfer by the ABC Partnership to X Corporation.

Example (5). (i) The facts are the same as in Example (4) except that partnership ABC transfers 10 percent of the stock in X Corporation to each of eight partners, 20 percent to partner A, and cash to partner B.

(ii) Under subparagraph (1)(i) of this paragraph, with respect to all of the partners (including partner A) except partner B, paragraph (a)(1) of § 1.50A-3 does not apply

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to the March 15, 1973, transfer by the ABC Partnership. Paragraph (a)(1) of § 1.50A-3 applies with respect to partner B's $2,000 share of the WIN expenses. See paragraph (a)(2) of § 1.50A-7.

Example (6). (i) X Corporation operates a manufacturing business and a separate retail sales business. During the month of January 1972, X incurred WIN expenses in its manufacturing business. On February 10, 1973, X transfers all the assets used in its manufacturing business to Partnership XY in exchange for a 50 percent interest in such partnership.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a)(1) of § 1.50A-3 does not apply to the February 10, 1973, transfer to Partnership XY.

[T.D. 7263, 38 FR 6156, Mar. 7, 1973; 38 FR 8656, Apr. 5, 1973]

§ 1.50A-5 Electing small business corporations.

(a) *In general*—(1) *Termination of employment by a corporation.* If an electing small business corporation (as defined in section 1371(b)) or a former electing small business corporation terminates (in a termination subject to the provisions of paragraph (a) of § 1.50A-3) the employment of any WIN employee with respect to whom WIN expenses have been paid or incurred, a recapture determination shall be made under § 1.50A-3 with respect to each shareholder who is treated, under paragraph (a) of § 1.50B-2 as a taxpayer who paid or incurred such expenses. Each such recapture determination shall be made with respect to the pro rata share of the WIN expenses of such employee which were taken into account by such shareholder under paragraph (a) of § 1.50B-2. For purposes of each such recapture determination the period of employment of such employee or employees shall be the period beginning with the initial date of employment (as defined in paragraph (c)(1) of § 1.50A-3) with respect to the electing small business corporation and ending with the date of such employee's termination (as defined in paragraph (a)(1)(ii) of § 1.50A-3). For the definition of the term "recapture determination" see paragraph (a)(3) of § 1.50A-3.

(2) *Disposition of shareholder's interest.* (i) If—

(*a*) WIN expenses are apportioned to a shareholder of an electing small business corporation who takes such expenses into account in computing his WIN expenses, and

(*b*) After the end of the shareholder's taxable year in which such apportionment was taken into account and before the close of the period to which paragraph (a)(1) of § 1.50A-3 applies with respect to the employee to which such WIN expenses relate, such shareholder's proportionate stock interest in such corporation is reduced (for example, by a sale or redemption, or by the issuance of additional shares) below the percentage specified in subdivision (ii) of this subparagraph,

then, on the date of such reduction the employment of such employee shall be deemed terminated with respect to such shareholder to the extent of the actual reduction in such shareholder's proportionate stock interest. (For example, if $100 of WIN expenses were apportioned to a shareholder and if his proportionate stock interest is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then the employment of the employee to which such WIN expenses relate shall be deemed terminated as to that shareholder to the extent of $50.) Accordingly, a recapture determination shall be made with respect to such shareholder. For purposes of such recapture determination the period of employment of any employee or employees with respect to whom WIN expenses were paid or incurred shall be the period beginning with the initial date of employment (as defined in paragraph (c)(1) of § 1.50A-3) with respect to the electing small business corporation and ending with the date on which such reduction occurs.

(ii) The percentage referred to in subdivision (i)(*b*) of this subparagraph is 66⅔ percent of the shareholder's proportionate stock interest in the corporation on the date of the apportionment under paragraph (a) of § 1.50B-2. However, once employment of an employee has been treated under this subparagraph as having terminated with respect to the shareholder to any extent, the percentage referred to shall be 33⅓ percent of the shareholder's proportionate stock interest in the

corporation on the date of apportionment under paragraph (a) of § 1.50B-2.

(iii) In determining a shareholder's proportionate stock interest in a former electing small business corporation for purposes of this subparagraph, the shareholder shall be considered to own stock in such corporation which he owns directly or indirectly (through ownership in other entities provided such other entities' bases in such stock are determined in whole or in part by reference to the basis of such stock in the hands of the shareholder). For example, if A, who owns all of the 100 shares of the outstanding stock of corporation X, a corporation which was formerly an electing small business corporation, transfers on November 1, 1973, 70 shares of X stock to corporation Y in exchange for 90 percent of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own 93 percent of the stock of X, 30 percent directly and 63 percent indirectly (i.e., 90 percent of 70). Any taxpayer who seeks to establish his interest in the stock of a former electing small business corporation under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the corporation after any such transfer or transfers.

(3) *Computation of the first 12 months of employment.* The period described in paragraph (a)(1) of § 1.50A-3 shall not be affected by a change in the shareholders in such corporation and shall not be affected by a reduction in any shareholder's proportionate stock interest in such corporation (for example, by a sale or redemption or by the issuance of additional shares). Thus, the first 12 months of employment (whether or not consecutive) of any WIN employee shall be the same with respect to any shareholder who is allowed a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee. Also, such first 12 months of employment and the period described in section 50B(c)(4) with respect to any WIN employee shall not be deemed to begin again in the case of a corporation making a valid election under section 1372.

(b) *Election of a small business corporation under section 1372*—(1) *General rule.* If a corporation makes a valid election under section 1372 to be an electing small business corporation (as defined in section 1371(b)), then on the last day of the first taxable year immediately preceding the taxable year for which such election is effective, the employment of any WIN employees whose initial date of employment (as defined in paragraph (c)(1) of § 1.50A-3) occurred in taxable years prior to the first taxable year for which the election is effective (and whose employment has not been terminated prior to such last day) shall be considered as having been terminated on such last day with respect to the WIN expenses paid or incurred by such corporation and § 1.50A-3 shall apply to such corporation. However, if the corporation and each of the persons who are shareholders of the corporation on the first day of the first taxable year for which the election under section 1372 is to be effective, or on the date of such election, whichever is later, execute the agreement specified in subparagraph (2) of this paragraph, § 1.50A-3 shall not apply with respect to any such WIN expenses by reason of the election by the corporation under section 1372.

(2) *Agreement of shareholders and corporation.* (i) The agreement referred to in subparagraph (1) of this paragraph shall be signed by the shareholders and by the corporation. The agreement shall recite that:

(*a*) In the event the employment of any WIN employee described in subparagraph (1) of this paragraph is later terminated (in a termination subject to the rules contained in paragraph (a) of § 1.50A-3) during a taxable year of the corporation for which the election under section 1372 is effective, each signer agrees to notify the district director or the director of the Internal Revenue service center of such termination, and agrees to be jointly and severally liable to pay to the district director or the director of the Internal Revenue service center an amount equal to the increase in tax which would have been imposed by

§ 1.50A-3 on the corporation but for the agreement under this paragraph.

(*b*) In the event any WIN employee described in subparagraph (1) of this paragraph is paid wages (as defined in section 50B(b) and paragraph (b) of § 1.50B-1) by such electing corporation, which are less than the wages paid to other employees of such electing corporation who perform comparable services (as defined in paragraph (a)(2)(ii) of § 1.50A-3), during a taxable year of the corporation for which the election under section 1372 is effective, each signer agrees to notify the district director or the director of the Internal Revenue service center of such failure to pay equal wages for comparable services, and agrees to be jointly and severally liable to pay to the district director or the director of the Internal Revenue service center an amount equal to the increase in tax which would have been imposed by § 1.50A-3 on the corporation as a result of such failure but for the election under section 1372.

For purposes of computing the period described in paragraph (a)(1) of § 1.50A-3, the period of employment by the corporation before the election under section 1372 shall be added to the period of employment by the electing small business corporation after such election.

(ii) The agreement shall set forth the name, address, and taxpayer account number of each party and the internal revenue district or service center in which each such party files his or its income tax return for the taxable year which includes the last day of the corporation's taxable year immediately preceding the first taxable year for which the election under section 1372 is effective. The agreement may be signed on behalf of the corporation by any person who is duly authorized. The agreement shall be filed with the district director or the director of the Internal Revenue service center with whom the corporation files its income tax return for its taxable year immediately preceding the first taxable year for which the election under section 1372 is effective and shall be filed on or before the due date (including extensions of time) of such return. For purposes of the preceding sentence, the district director or the director of the Internal Revenue service center may, if good cause is shown, permit the agreement to be filed on a later date.

(c) *Examples.* This section may be illustrated by the following examples:

Example (1). (i) X Corporation, an electing small business corporation which makes its returns on the basis of the calendar year, hired employees under a WIN program on July 1, 1972, and incurred expenses for such employees during the following 12 months at an initial rate of $10,000 per month. For taxable year 1972, X Corporation had 20 shares of stock outstanding which were owned equally by A and B who make their returns on the basis of a calendar year. Under paragraph (a) of this section, the WIN expenses were apportioned to the shareholders of X Corporation as follows:

	Period ending Dec. 31, 1973
Total WIN expenses for the taxable year	$60,000
Shareholder A (10/20)	30,000
Shareholder B (10/20)	30,000

Assuming that during 1972 shareholders A and B did not directly incur any WIN expenses and that they did not own any interest in other electing small business corporations, partnerships, estates, or trusts incurring WIN expenses, the WIN expenses attributable to each shareholder is $30,000. For the taxable year 1972, each shareholder's credit earned of $6,000 (20 percent of $30,000) was allowed under section 40 as a credit against his liability for tax.

(ii) On January 1, 1973, X Corporation terminates the employment of the employees accounting for 50 percent of its WIN expenses incurred to that date, or $30,000 in salaries and wages. The actual period of employment for these WIN employees was 6 months. For taxable year 1972, each shareholder's recomputed credit is $3,000 (20 percent of $15,000). The income tax imposed by chapter 1 of the Code on each of the shareholders for the taxable year 1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is, $6,000 original credit earned minus $3,000 recomputed credit earned).

Example (2). (i) The facts are the same as in subdivision (i) of example (1), except that on January 1, 1973, shareholder A sells five of his 10 shares of stock in X Corporation to C. No other changes in stock ownership occurred during 1973. Under paragraph (a)(2) of this section, the WIN expenses of X Corporation were apportioned on December 31,

1973, to the shareholders of X Corporation as follows:

	Period ending Dec. 31, 1972
Total WIN expenses for the taxable year	$60,000
Shareholder A (5/20)	15,000
Shareholder B (10/20)	30,000
Shareholder C (5/20)	15,000

(ii) Under paragraph (a)(2) of this section, on January 1, 1973, the employment of these WIN employees shall be deemed terminated by shareholder A with respect to 50 percent of the WIN expenses allocated to him since immediately after the January 1, 1973, sale A's proportionate stock interest in X Corporation is reduced to 50 percent of the proportionate stock interest in X Corporation which he held for taxable year 1972. The actual period of employment of the WIN employees accounting for the 50 percent of the WIN expenses originally allocated to A is 6 months (that is, the period beginning with July 1, 1972, and ending with January 1, 1973). The income tax imposed by chapter 1 of the Code on shareholder A for the taxable year 1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is, $6,000 original credit earned minus $3,000 recomputed credit earned).

(d) *Termination or revocation of an election under section 1372.* The employment of employees with respect to whom WIN expenses were paid or incurred shall not be considered to have been terminated solely by reason of a termination or revocation of a corporation's election under section 1372.

[38 FR 6158, Mar. 7, 1973]

§ 1.50A-6 Estates and trusts.

(a) *In general*—(1) *Termination of employment by an estate or trust.* If an estate or trust teminates (in a termination subject to the provisions of paragraph (a) of § 1.50A-3) the employment of any employee with respect to whom WIN expenses have been paid or incurred, a recapture determination shall be made under § 1.50A-3 with respect to the estate or trust, and each beneficiary who is treated, under paragraph (a) of § 1.50B-3 as a taxpayer who paid or incurred such expenses. For purposes of each such recapture determination the period of employment of such employees shall be the period beginning with the initial date of employment (as defined in paragraph (c)(1) of § 1.50A-3) with respect to the estate or trust and ending with the date of such employee or employees' termination (as defined in paragraph (a)(1)(ii) of § 1.50A-3). For definition of "recapture determination" see paragraph (a)(3) of § 1.50A-3.

(2) *Disposition of interest.* (i) If—

(*a*) WIN expenses are apportioned to an estate or trust, or to a beneficiary of an estate or trust who takes such expenses into account in computing his WIN expenses, and

(*b*) After the end of the estate's, trust's, or beneficiary's taxable year in which such apportionment was taken into account and before the close of the period to which paragraph (a)(1) of § 1.50A-3 applies with respect to the employees to which such WIN expenses relate, such estate's, trust's, or such beneficiary's proportionate interest in the income of the estate or trust is reduced (for example, by a sale, or by the terms of the estate or trust instrument) below the percentage specified in subdivision (ii) of this subparagraph,

then, on the date of such reduction, the employment of such employee shall be deemed terminated with respect to such estate, trust, or beneficiary to the extent of the actual reduction in such estate's, trust's, or beneficiary's proportionate interest in the income of the estate or trust. (For example, if $100 of WIN expenses were apportioned to a beneficiary and if his proportionate interest in the income of the estate or trust is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then the employment of the employee to which such WIN expenses relates shall be deemed terminated as to that beneficiary to the extent of $50.) Accordingly, a recapture determination shall be made with respect to such estate, trust, or beneficiary. For purposes of such recapture determination the period of employment of any employee or employees with respect to whom WIN expenses were paid or incurred shall be the period beginning with the initial date of employment (as defined in paragraph (c)(1) of § 1.50A-3) with respect to the estate or trust and

ending with the date on which such reduction occurs.

(ii) The percentage referred to in subdivision (i)(*b*) of this subparagraph is 66⅔ percent of the estate's, trust's, or beneficiary's proportionate interest in the income of the estate or trust for the taxable year of the apportionment under paragraph (a) of § 1.50B-3. However, once employment of an employee has been treated under this subparagraph as having terminated with respect to the estate, trust, or beneficiary to any extent, the percentage referred to shall be 33⅓ percent of the estate's, trust's, or beneficiary's proportionate interest in the income of the estate or trust for the taxable year of the apportionment under paragraph (a) of § 1.50B-3.

(iii) In determining a beneficiary's proportionate interest in the income of an estate or trust for purposes of this subparagraph, the beneficiary shall be considered to own any interest in such an estate or trust which he owns directly or indirectly (through ownership in other entities provided such other entities' bases in such interests are determined in whole or in part by reference to the basis of such interest in the hands of the beneficiary). For example, if A, whose proportionate interest in the income of trust X is 30 percent, transfers all of such interest to corporation Y in exchange for all of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own a 30-percent interest in trust X. Any taxpayer who seeks to establish his interest in an estate or trust under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the estate or trust after any such transfer or transfers.

(b) *Computation of the first 12 months of employment.* The period described in paragraph (a)(1) of § 1.50A-3 shall not be affected by a change in the beneficiaries of an estate or trust and shall not be affected by a reduction or a termination of a beneficiary's interest in the income of such estate or trust. Thus, the period described in paragraph (a)(1) of § 1.50A-3 for any WIN employee shall be the same with respect to a trust or estate and any beneficiary of such trust or estate which is allowed a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee. Also, such period with respect to any WIN employee shall not be deemed to begin again as the result of the acquisition of the interest by another.

(c) *Examples.* Paragraph (a) of this section may be illustrated by the following examples:

Example (1). (i) XYZ Trust, which makes its returns on the basis of the calendar year, hired employees under the WIN program on July 1, 1972, and incurred expenses for such employees during the following 12 months at an initial rate of $10,000 per month. For the taxable year 1972 the income of XYZ Trust is $60,000, which is allocated equally to XYZ Trust and beneficiary A. Beneficiary A makes his returns on the basis of a calendar year. Under paragraph (a) of this section, the WIN expenses were apportioned to XYZ Trust and to beneficiary A as follows:

	Period ending Dec. 31, 1972
Total WIN expenses for the taxable year	$60,000
XYZ Trust ($30,000/$60,000)	30,000
Beneficiary A ($30,000/$60,000)	30,000

Assuming that during 1972 beneficiary A did not directly incur any WIN expenses and that he did not own any interest in other estates, trusts, electing small business corporations, or partnerships incurring WIN expenses, the WIN expenses incurred by XYZ Trust and by beneficiary A are $30,000 each. For the taxable year 1972, XYZ Trust and beneficiary A each had a credit earned of $6,000. Each credit earned was allowed under section 40 as a credit against the liability for tax.

(ii) On January 1, 1973, XYZ Trust terminates the employment of its employees accounting for 50 percent of its WIN expenses incurred to that date, or $30,000 in salaries and wages. The actual period of employment for these WIN employees was 6 months. For the taxable year 1972, XYZ Trust's and beneficiary A's recomputed credit is $3,000 (20 percent of $15,000). The income tax imposed by chapter 1 of the Code on XYZ Trust and on beneficiary A for the taxable year 1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is, $6,000 original credit earned minus $3,000 recomputed credit earned).

Example (2). (i) The facts are the same as in subdivision (i) of example (1), except that on January 1, 1973, beneficiary A sells 50 percent of his interest in the income of XYZ Trust to B. No other changes in income interest occurred during 1973. Under paragraph (a)(2) of § 1.50B-4, each beneficiary's share and the trust's share of the WIN expenses are apportioned as follows:

	Period ending Dec. 31, 1972
Total WIN expenses for the taxable year	$60,000
XYZ Trust ($30,000/$60,000)	30,000
Beneficiary A ($15,000/$60,000)	15,000
Beneficiary B ($15,000/$60,000)	15,000

(ii) Under paragraph (a)(2) of this section, on January 1, 1973, the employment of these WIN employees shall be deemed terminated by beneficiary A with respect to 50 percent of the WIN expenses allocated to him since immediately after the January 1, 1973, sale A's proportionate interest in the income of XYZ Trust is reduced to 50 percent of his proportionate interest in the income of XYZ Trust for the taxable year 1972. The period of employment of the WIN employees accounting for the 50 percent of the WIN expense originally allocated to A is 6 months (that is, the period beginning with July 1, 1972, and ending with December 31, 1972). For the taxable year 1972 beneficiary A's recomputed credit earned is $3,000 (20 percent of $15,000). The income tax imposed by chapter 1 of the Code on beneficiary A for the taxable year 1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is, $6,000 original credit earned minus $3,000 recomputed credit earned).

[38 FR 6159, Mar. 7, 1973]

§ 1.50A-7 Partnerships.

(a) *In general*—(1) *Termination of employment by a partnership.* If a partnership terminates (in a termination subject to the provisions of paragraph (a) of § 1.50A-3) the employment of any WIN employee with respect to whom WIN expenses have been paid or incurred, a recapture determination shall be made under § 1.50A-3 with respect to each partner who is treated, under paragraph (a) of § 1.50B-4, as a taxpayer with respect to such expenses. Each such recapture determination shall be made with respect to the share of the WIN expenses with respect to such employee which were taken into account by such partner under paragraph (a) of § 1.50B-4. For purposes of each such recapture determination the period of employment of any such employee shall be the period beginning with the initial date of employment (as defined in paragraph (c)(1) of § 1.50A-3) with respect to the partnership and ending with the date of such employee's termination (as defined in paragraph (a)(1)(ii) of § 1.50A-3). For the definition of "recapture determination" see paragraph (a)(3) of § 1.50A-3.

(2) *Disposition of partner's interest.* (i) If—

(*a*) WIN expenses are allocated to a partner of a partnership who takes such expenses into account in computing his WIN expenses, and

(*b*) After the end of the partner's taxable year in which such allocation was taken into account and before the close of the period to which paragraph (a)(1) of § 1.50A-3 applies with respect to the employee to which such WIN expenses relate, such partner's proportionate interest in the general profits of the partnership (or in the particular expenses) is reduced (for example, by a sale, by a change in the partnership agreement, or by the admission of a new partner) below the percentage specified in subdivision (ii) of this subparagraph,

then, on the date of such reduction the employment of such employee shall be deemed terminated with respect to such partner to the extent of the actual reduction in such partner's proportionate interest in the general profits (or in the particular expenses) of the partnership. (For example, if $100 of WIN expenses were taken into account by a partner and if his proportionate interest in the general profits of the partnership is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then the employment of the employee to which such WIN expenses relate shall be deemed terminated as to that partner to the extent of $50.) Accordingly, a recapture determination shall be made with respect to such partner. For purposes of such recapture determination the period of employment of any employee or employees with respect to whom WIN expenses were paid or incurred shall be the period beginning with the initial date of employment

(as defined in paragraph (c)(1) of § 1.50A-3) with respect to the partnership and ending with the date on which such reduction occurs.

(ii) The percentage referred to in subdivision (i) (*b*) of this subparagraph is 66⅔ percent of the partner's proportionate interest in the general profits (or in the WIN expenses) of the partnership for the year of the apportionment under § 1.50B-4(a). However, once employment of an employee has been treated under this subparagraph as having terminated with respect to the partner to any extent, the percentage referred to shall be 33⅓ percent of the partner's proportionate interest in the general profits (or in the WIN expenses) of the partnership for the taxable year of the apportionment under paragraph (a) of § 1.50B-4.

(iii) In determining a partner's proportionate interest in the general profits (or in the WIN expenses) of a partnership for purposes of this subparagraph, the partner shall be considered to own any interest in such a partnership which he owns directly or indirectly (through ownership in other entities provided the other entities' bases in such interests are determined in whole or in part by reference to the basis of such interest in the hands of the partner). For example, if A, whose proportionate interest in the general profits of partnership X is 20 percent, transfers all of such interest to Corporation Y in exchange for all of the stock of Y in a transaction to which section 351 applies then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own a 20 percent interest in partnership X. Any taxpayer who seeks to establish his interest in a partnership under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the partnership after any such transfer or transfers.

(3) *Computation of the first 12 months of employment.* The period described in paragraph (a)(1) of § 1.50A-3 shall not be affected by a change in the partners of such partnership and shall not be affected by a change in the ratio in which the partners divide the general profits (or the WIN expenses) of the partnership. Thus, such period for any WIN employee shall be the same with respect to any partner claiming a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee.

(b) *Examples.* Paragraph (a) of this section may be illustrated by the following examples:

Example (1). (i) AB partnership, which makes its returns on the basis of the calendar year, hired employees under the WIN program on July 1, 1972, and incurred expenses for such employees during the following 12 months at an initial rate of $10,000 per month. Partners A and B, who make their returns on the basis of a calendar year, share the profits and losses of AB partnership equally. Under paragraph (a)(2) of this section, each partner's share of the WIN expenses was approportioned as follows:

	Period ending Dec. 31, 1972
Total WIN expenses for the taxable year	$60,000
Partner A's share (50 percent)	30,000
Partner B's share (50 percent)	30,000

Assuming that during 1972 A and B did not directly incur any WIN expenses and that they did not own any interest in other partnerships, electing small business corporations, estates, or trusts incurring WIN expenses, each partner's share of the WIN expenses is $30,000. For the taxable year 1972, each partner's credit earned of $6,000 (20 percent of $30,000) was allowed under section 40 as a credit against his liability for tax.

(ii) On January 1, 1973, AB partnership terminates the employment of its employees accounting for 50 percent of its WIN expenses incurred to that date, or $30,000 in salaries and wages. The actual period of em ployment for these WIN employees was 6 months. For the taxable year 1972, each partner's recomputed credit earned is $3,000 (20 percent of $15,000). The income tax imposed by chapter 1 of the Code on each of the partners for the taxable year 1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is, $6,000 original credit earned minus $3,000 recomputed credit earned).

Example (2). (i) The facts are the same as in subdivision (i) of example (1), except that on January 1, 1973, partner A sells one-half of his 50 percent interest in AB partnership to C, to form the ABC partnership. No other changes in the partners' proportionate interest in the general profits of the partnership occurred during 1973. Under paragraph (a)(2) of this section, each par-

ner's share of the WIN expenses was apportioned on December 31, 1973, as follows:

	Period ending Dec. 31, 1973
Total WIN expenses for the taxable year	$60,000
Partner A's share (25 percent)	15,000
Partner B's share (50 percent)	30,000
Partner C's share (25 percent)	15,000

(ii) Under paragraph (a)(2) of this section, on January 1, 1973, the employment of these WIN employees shall be deemed terminated by partner A with respect to 50 percent of the WIN expenses allocated to him since immediately after the January 1, 1973, sale, A's proportionate interest in the general profits of ABC partnership is reduced to 50 percent of his proportionate interest in the general profits of AB partnership for 1972. The period of employment of the WIN employees accounting for the 50 percent of the WIN expenses originally allocated to A is 6 months (that is, the period beginning with July 1, 1972, and ending with December 31, 1972). For the taxable year 1972 partner A's recomputed credit earned is $3,000 (20 percent of $15,000). The income tax imposed by chapter 1 of the Code on partner A for the taxable year 1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is, $6,000 original credit earned minus $3,000 recomputed credit earned).

[38 FR 6160, Mar. 7, 1973]

§ 1.50B–1 Definitions of WIN expenses and WIN employees.

(a) *WIN expenses*—(1) *In general.* Except as otherwise provided in paragraphs (b)–(g) of this section, for purposes of §§ 1.50A–1 through 1.50B–5, the term "work incentive program expenses" (referred to in §§ 1.50A–1 through 1.50B–5 as "WIN expenses") means the salaries and wages paid or incurred by the taxpayer for services rendered during the first 12 months of employment (whether or not consecutive) by an employee who is certified by the Secretary of Labor as—

(i) Having been placed in employment by the taxpayer (or if the taxpayer is a partner of a partnership, beneficiary of an estate or trust, or a shareholder of an electing small business corporation, by such partnership, estate, trust, or electing small business corporation) under a work incentive (WIN) program established under section 432(b)(1) of the Social Security Act (42 U.S.C. 632(b)(1)), and

(ii) Not having displaced any individual from employment.

The term "WIN expenses" includes only salaries and wages paid or incurred in taxable years beginning after December 31, 1971. See paragraph (c) of § 1.50A–3 for rules relating to the determination of the first 12 months of employment (whether or not consecutive).

(2) *Examples.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). X Corporation, an accrual basis taxpayer which files its return on the basis of the calendar year, hired an employee on July 1, 1971, who was certified by the Secretary of Labor under this paragraph. The first 12 months of employment were continuous. X is entitled to the credit provided by section 40 with respect to the salaries or wages incurred during its taxable year beginning January 1, 1972, for services rendered by that employee during the period beginning July 1, 1971, and ending June 30, 1972.

Example (2). Y, a cash basis taxpayer who files his return on the basis of the calendar year, employed A, an employee certified by the Secretary of Labor under this paragraph, on July 1, 1971. A's first 12 months of employment were continuous. Y paid A on the basis of a semimonthly payroll period, but paid his payroll 2 days after the close of the payroll period during which the wages were earned. Thus, Y paid A on January 2, 1972, for services rendered between December 16, 1971, and December 31, 1971. Y is entitled to the credit provided by section 40 with respect to the wages paid for services rendered by A during the period beginning December 16, 1971, and ending June 30, 1972, because those wages were paid by Y in a taxable year beginning after December 31, 1971.

(b) *Salaries and wages.* For purposes of this section, the term "salaries and wages" means only cash remuneration including a check. Amounts deducted and withheld from the employee's pay (for example, taxes and contributions to health and retirement plans) shall be deemed to be cash remuneration even though not actually paid directly to the employee.

(c) *Trade or business expenses.* The term "WIN expenses" includes only salaries and wages which are paid or incurred in a trade or business of the taxpayer and which are deductible in

computing taxable income. Thus, salaries and wages paid to domestic employees in a private home are not "WIN expenses".

(d) *Reimbursed expenses*—(1) *In general.* The term "WIN expenses" does not include salaries and wages to the extent that the taxpayer is reimbursed for such salaries or wages from any source.

(2) *Example.* Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. X Company, which makes its return on the basis of the calendar year, hired WIN employees on January 1, 1972. X Company has a cost-plus construction contract with the Federal Government. The fact that X has a construction contract with the Federal Government or anyone else does not change its character from a normal business transaction in which there has been a sale of materials and services. Thus, the salaries or wages paid or incurred for services rendered by these WIN employees would not be reimbursed expenses, and X would be entitled to the credit provided by section 40.

(e) *Geographical limitation*—(1) *In general.* The term "WIN expenses" does not include salaries and wages paid or incurred for services rendered outside the United States (as defined in sections 638 (relating to Continental Shelf areas) and 7701(a)(9). However, services rendered by any WIN employee outside the United States (as defined in sections 638 (relating to Continental Shelf areas) and 7701(a)(9)) shall contribute to such employee's first 12 months of employment (whether or not consecutive) for purposes of paragraph (a) of § 1.50A-3 and paragraph (a) of this section.

(2) *Example.* Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. X Corporation, which files its return on the basis of the calendar year, hired A, a WIN employee, on January 1, 1972, and continuously employed him for the following 24-month period. During January and February of 1972, X paid A's wages while he received training conducted in Puerto Rico. For the remainder of the calendar year A performed services for X within the United States. For purposes of paragraph (a) of § 1.50A-3 and paragraph (a) of this section, A's first 12 months of employment are January 1, 1972, to December 31, 1972. Under subparagraph (1) of this paragraph no wages paid to A for services rendered during the months of January and February of 1972 may be taken into account by X under paragraph (a) of this section as WIN expenses because the services were rendered outside the United States. However, X may take into account wages he has incurred with respect to A for the period March 1, 1972, to December 31, 1972.

(f) *Maximum period of training or instruction.* The term "WIN expenses" does not include salaries and wages paid or incurred for services rendered by a WIN employee after the end of the 24-month period beginning with the date of initial employment (as defined in paragraph (c)(1) of § 1.50A-3) of the WIN employee.

(g) *Ineligible individuals.* The term "WIN expenses" does not include salaries and wages paid or incurred for services rendered by a WIN employee who—

(1) Bears any of the relationships described in paragraphs (1) through (8) of section 152(a) of the Code to the taxpayer, or, if the taxpayer is a corporation, to an individual who owns, directly or indirectly, more than 50 percent in value of the outstanding stock of the corporation (determined with the application of section 267(c) of the Code),

(2) If the taxpayer is an estate or trust, is a grantor, beneficiary, or fiduciary of the estate or trust, or is an individual who bears any of the relationships described in paragraphs (1) through (8) of section 152(a) of the Code to a grantor, beneficiary, or fiduciary of the estate or trust, or

(3) Is a dependent (described in section 152(a)(9) of the Code) of the taxpayer, or, if the taxpayer is a corporation, of an individual described in subparagraph (1), or, if the taxpayer is an estate or trust, of a grantor, beneficiary, or fiduciary of the estate or trust.

(h) *WIN employee.* For purposes of §§ 1.50A-1—1.50B-5 the term "WIN employee" means an employee who is certified by the Secretary of Labor as meeting the requirements of paragraph (a)(1) (i) and (ii) of this section.

(i) [Reserved]

(j) *Special rule applicable to transactions to which section 381(a) applies and transactions involving a mere change in form of conducting a trade*

or business. The first 12 months of employment (whether or not consecutive) and the period described in section 50B (c)(4) of any WIN employee, for purposes of determining the amount of WIN expenses (as defined in paragraph (a) of § 1.50B–1), shall not be affected by transactions to which the rule contained in paragraph (f) (relating to transaction to which section 381(a) (relating to certain corporate acquisitions) applies), or paragraph (g) (relating to a mere change in form of conducting a trade or business) of § 1.50A–4 applies.

[38 FR 6161, Mar. 7, 1973]

§ 1.50B–2 Electing small business corporations.

(a) *General rule*—(1) *In general.* In the case of an electing small business corporation (as defined in section 1371 (b)), WIN expenses (as defined in paragraph (a) of § 1.50B–1) shall be apportioned pro rata among the persons who are shareholders of such corporation on the last day of such corporation's taxable year, and shall be taken into account for the taxable years of such shareholders within which or with which the taxable year of such corporation ends. The WIN expenses for each employee shall be apportioned separately. In determining who are shareholders of an electing small business corporation on the last day of its taxable year, the rules of paragraph (d)(1) of § 1.1371–1 and of paragraph (a)(2) of § 1.1373–1 shall apply.

(2) *Shareholder as taxpayer.* A shareholder to whom WIN expenses are apportioned shall, for purposes of the credit allowed by section 40, be treated as the taxpayer who paid or incurred the expenses allocated to him. If a shareholder takes into account in determining his WIN expenses any WIN expenses with respect to an employee of an electing small business corporation, and if the employment of such employee is terminated in a termination subject to the rules contained in paragraph (a) of § 1.50A–3, or if the electing small business corporation fails to pay comparable wages and such failure is subject to the rules contained in paragraph (a) (2) and (3) of § 1.50A–3, then such shareholder shall make a recapture determination under the provisions of section 50A (c) and (d) of the Code and § 1.50A–3. See § 1.50A–5.

(3) *Computation of the first 12 months of employment.* The first 12 months of employment (whether or not consecutive) and the period described in section 50B(c)(4) of any WIN employee for purposes of determining the amount of WIN expenses (as defined in paragraph (a) of § 1.50B–1) shall not be affected by a change in the shareholders in such corporation and shall not be affected by a reduction in any shareholder's proportionate stock interest in such corporation (for example, by a sale or redemption or by the issuance of additional shares). Thus, the first 12 months of employment (whether or not consecutive) of any WIN employee shall be the same with respect to any shareholder claiming a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee. Also, such first 12 months of employment and the period described in section 50B(c)(4), with respect to any WIN employee, shall not be deemed to begin again because of the making of a valid election under section 1372.

(b) *Summary statement.* An electing small business corporation shall attach to its return a statement showing the apportionment to each shareholder of its WIN expenses with respect to each WIN employee.

(c) *Examples.* Paragraph (a) of this section may be illustrated by the following examples:

Example (1). (i) X Corporation, an electing small business corporation which files its returns on the basis of the calendar year, hired WIN employees on July 1, 1972, whose employment was continuous for the next 24 months. A, a shareholder, has a 10 percent interest in X Corporation. X Corporation incurred $24,000 in wages with respect to these WIN employees in calendar year 1972, and $48,000 in calendar year 1973. Assuming that during 1972 shareholder A did not directly incur any other WIN expenses and did not own any other interest in other electing small business corporations, partnerships, estates, or trusts that incurred WIN expenses, for taxable year 1972 shareholder A's credit earned of $480 (10 percent (A's ownership interest) multiplied by $24,000 of WIN expenses multiplied by 20

percent) was allowed under section 40 as a credit against his liability for tax.

(ii) On March 1, 1973, shareholder A sold all of his interest to B, a new shareholder. Therefore, the employment of the WIN employees is deemed terminated for purposes of paragraph (a) of § 1.50A–3 with respect to shareholder A. For taxable year 1972, A's recomputed credit is zero because the termination occurred before the end of the period described in paragraph (a)(1) of § 1.50A–3. The income tax imposed by chapter 1 of the Code on A for the taxable year 1973 is increased by the $480 decrease in his credit earned for the taxable year 1972 (that is, $480 original credit earned minus zero recomputed credit earned). Under paragraph (a) of this section A has no credit earned for 1973.

(iii) Under paragraph (a)(1) of this section, assuming that during 1973 shareholder B did not directly incur any other WIN expenses and that he did not own any interest in other electing small business corporations, partnerships, estates, or trusts that incurred WIN expenses, shareholder B's credit earned is $480 (10 percent (B's ownership interest) multiplied by $24,000 of WIN expenses multiplied by 20 percent) and is allowable under section 40 as a credit against his liability for tax. Under paragraph (a)(3) for purposes of determining the period of employment that may be taken into account by B the initial date of employment of these WIN employees relates back to the date they were first employed, *i.e.*, July 1, 1972. Thus, the first 12 months of employment ends on June 30, 1973.

Example (2). (i) Y Corporation, an electing small business corporation which files its return on the basis of the calendar year, hires five WIN employees in 1972. The WIN expenses incurred with respect to each employee are as follows:

WIN employee No.	WIN expenses
1	$6,000
2	5,000
3	4,000
4	4,000
5	3,000
Total	22,000

On December 31, 1972, Y Corporation has 10 shares of stock outstanding which are owned as follows: A owns 3 shares, B owns 2 shares, and C owns 5 shares.

(ii) Under this section, the WIN expenses are apportioned to the shareholders of Y Corporation as follows:

WIN employees	1	2	3	4	5	Total
Total WIN expenses	$6,000	$5,000	$4,000	$4,000	$3,000	
Shareholder A (3/10)	1,800	1,500	1,200	1,200	900	6,600
Shareholder B (2/10)	1,200	1,000	800	800	600	4,400
Shareholder C (5/10)	3,000	2,500	2,000	2,000	1,500	11,000

Assume that shareholders A, B, and C did not directly incur any other WIN expenses during their taxable year in which falls December 31, 1972 (the last day of Y Corporation's taxable year), and that such shareholders did not own any interest in other electing small business corporations, partnerships, estates or trust that incurred WIN expenses. The total WIN expenses of shareholder A are $6,600, of shareholder B are $4,400, and of shareholder C are $11,000.

[38 FR 6162, Mar. 7, 1973]

§ 1.50B–3 Estates and trusts.

(a) *General rule*—(1) *In general.* In the case of an estate or trust, WIN expenses (as defined in paragraph (a) of § 1.50B–1) shall be apportioned among the estate or trust and its beneficiaries on the basis of the income of such estate or trust allocable to each. There shall be apportioned to the estate or trust for its taxable year, and to each beneficiary of such estate or trust for his taxable year in which or with which the taxable year of such estate or trust ends, his share (as determined under paragraph (b) of this section) of the total WIN expenses. The WIN expenses for each employee shall be apportioned separately.

(2) *Beneficiary as taxpayer.* A beneficiary to whom WIN expenses are apportioned shall, for purposes of the credit allowed by section 40, be treated as the taxpayer who paid or incurred such WIN expenses allocated to him. If a beneficiary takes into account in determining his WIN expenses any portion of the WIN expenses paid or incurred by an estate or trust and if the employee with respect to which the WIN expenses were paid or in-

curred is terminated in a termination subject to the rules in paragraph (a) of § 1.50A-3, or if there is a failure (which is subject to the rules is paragraph (a) (2) and (3) of § 1.50A-3) to pay such employee comparable wages then such beneficiary shall make a recapture determination under the provisions of section 50A (c) and (d) of the Code and § 1.50A-3. See § 1.50A-6.

(3) *Beneficiary.* For purposes of this section, the term "beneficiary" includes heir, legatee, and devisee.

(4) *Special rule for termination of interest.* If during the taxable year of an estate or trust a beneficiary's interest in the income of such estate or trust terminates, WIN expenses paid or incurred by such estate or trust after such termination shall not be apportioned to such beneficiary.

(b) *Share.* A trust's, estate's, or beneficiary's share of the WIN expenses with respect to each employee shall be:

(1) The total WIN expenses incurred in the taxable year of the estate or trust with respect to such employee, multiplied by

(2) The amount of income allocable to such estate or trust or to such beneficiary for such taxable year, divided by

(3) The sum of the amounts of income allocable to such estate or trust and all its beneficiaries taken into account under subparagraph (2) of this paragraph.

(c) *Limitation based on amount of tax.* In the case of an estate or trust, the $25,000 amount specified in section 50A(a)(2), relating to limitation based on amount of tax, shall be reduced for the taxable year to—

(1) $25,000, multiplied by

(2) The WIN expenses apportioned to such estate or trust under paragraph (a) of this section, divided by

(3) The WIN expenses apportioned among such estate or trust and its beneficiaries.

(d) *Computation of the first 12 months of employment.* The first 12 months of employment (whether or not consecutive) and the period described in section 50B(c)(4) of any WIN employee for purposes of determining the amount of WIN expenses (as defined in paragraph (a) of § 1.50B-1) shall not be affected by a change in the beneficiaries of an estate or trust and shall not be affected by a reduction or a termination of a beneficiary's interest in the income of such estate or trust. Thus, the first 12 months of employment (whether or not consecutive) of any WIN employee shall be the same with respect to trust or estate, and any beneficiary of such trust or estate claiming a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee.

(e) *Summary statement.* An estate or trust shall attach to its return a statement showing the apportionment of WIN expenses with respect to each employee to such estate or trust and to each beneficiary.

(f) *Examples.* This section may be illustrated by the following examples:

Example (1). (1) XYZ trust, which makes its return on the basis of the calendar year, hires five WIN employees in 1972. The WIN expenses incurred with respect to each employee are as follows:

WIN employee No.	WIN expenses
1	$6,000
2	5,000
3	4,000
4	4,000
5	3,000
Total	22,000

For the taxable year 1972 the income of XYZ trust is $10,000 which is allocable as follows: $5,000 to XYZ trust, $2,000 to beneficiary A, and $3,000 to beneficiary B. Beneficiaries A and B make their returns on the basis of a calendar year.

(2) Under this section, the WIN expenses are apportioned to XYZ trust and to its beneficiaries as follows:

WIN employees	1	2	3	4	5	Total
Total WIN expenses	$6,000	$5,000	$4,000	$4,000	$3,000	
XYZ Trust: $5,000/10,000	3,000	2,500	2,000	2,000	1,500	$11,000

WIN employees	1	2	3	4	5	Total
Beneficiary A: $2,000/10,000	1,200	1,000	800	800	600	4,400
Beneficiary B: $3,000/10,000	1,800	1,500	1,200	1,200	900	6,600

Assume that beneficiary A hired a WIN employee during his taxable year 1972 and incurred $6,000 in wages. Also, assume that beneficiary B did not hire WIN employees during his taxable year 1972 and that beneficiaries A and B did not own any interests in other trusts, estates, partnerships, or electing small business corporations that hired WIN employees. The WIN expenses of XYZ trust are $11,000, of beneficiary A are $10,400, and of beneficiary B are $6,600.

(3) In the case of XYZ trust, the $25,000 amount specified in section 50A(a)(2) is reduced to $12,500, computed as follows: (i) $25,000 multiplied by (ii) $11,000 (WIN expense apportioned to the trust), divided by (iii) $22,000 (total WIN expenses apportioned among such trust ($11,000), beneficiary A ($4,400), and beneficiary B ($6,600)).

Example (2). The facts are the same as in example (1) except that beneficiary A's interest is reduced to zero. Under paragraph (a)(2) for purposes of determining the period of employment that may be taken into account by XYZ trust and by beneficiary B, the initial date of employment of the WIN employees relates back to the date they were first employed.

[38 FR 6163, Mar. 7, 1973]

§ 1.50B-4 Partnerships.

(a) *General rule*—(1) *In general.* In the case of a partnership, each partner shall take into account separately, for his taxable year with or within which the partnership taxable year ends, his share (as determined under subparagraph (3) of this paragraph) of the WIN expenses (as defined in paragraph (a) of § 1.50B-1) of employees employed by the partnership during such partnership's taxable year. The WIN expenses for each employee shall be allocated separately.

(2) *Partner as taxpayer.* Each partner shall be treated as the taxpayer who paid or incurred the share of the WIN expenses allocated to him. If a partner takes into account in determining his WIN expenses the WIN expenses of an employee of a partnership, and if the employment of such employee is terminated in a termination subject to the rules contained in paragraph (a) of § 1.50A-3, or if the partnership fails to pay comparable wages and such failure is subject to the rules contained in paragraph (a)(2) and (3) of § 1.50A-3, then such partner shall make a recapture determination under the provisions of section 50A (c) and (d) of the Code and § 1.50A-3. See § 1.50A-7.

(3) *Determination of partner's share.* (i) Each partner's share of the WIN expenses shall be determined in accordance with the ratio in which the partners divide the general profits of the partnership (that is, the taxable income of the partnership as described in section 702 (a)(9)) regardless of whether the partnership has a profit or a loss for the taxable year during which the WIN expenses are paid or incurred. However, if the ratio in which the partners divide the general profits of the partnership changes during the taxable year of the partnership, the ratio effective for the date on which the WIN expenses are paid or incurred shall apply.

(ii) Notwithstanding subdivision (i) of this subparagraph, if the deduction with respect to any WIN expenses is specially allocated and if such special allocation is recognized under section 704 (a) and (b) and paragraph (b) of § 1.704-1, then each partner's share of the WIN expenses shall be determined by reference to such special allocation effective for the date on which the WIN expenses are paid or incurred.

(4) *Computation of the first 12 months of employment.* The first 12 months of employment (whether or not consecutive) and the period described in section 50B(c)(4) with respect to any WIN employee for purposes of determining the amount of WIN expenses (as defined in paragraph (a) of § 1.50B-1) shall not be affected by a change in the partners of such partnership and shall not be affected by a change in the ratio in which the partners divide the general profits of the partnership. Thus, the first 12 months of employment (whether or not consecutive) and the 24-month period described in section

50B(c)(4) of any WIN employee shall be the same with respect to any partner claiming a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee.

(b) *Summary statement.* A partnership shall attach to its return a statement showing the allocation to each partner of its WIN expenses with respect to each WIN employee.

(c) *Examples.* Paragraph (a) of this section may be illustrated by the following examples:

Example (1). Partnership ABCD hires a WIN employee on January 1, 1972, and hires a second WIN employee on September 1, 1972. The ABCD partnership and each of its partners reports income on the basis of the calendar year. Partners A, B, C, and D share partnership profits equally. Each partner's share of the WIN expenses incurred with respect to these employees is 25 percent.

Example (2). Assume the same facts as in example (1) and the following additional facts: A dies on June 30, 1972, and B purchases A's interest as of such date. Each partner's share of the profits from January 1 to June 30 is 25 percent. From July 1 to December 31, B's share of the profits is 50 percent, and C and D's share of the profits is 25 percent each. B shall take into account 25 percent of the WIN expenses incurred during the period beginning January 1 and ending June 30 and 50 percent of the WIN expenses incurred during the remainder of the year with respect to the employee hired on January 1, 1972. Also, B shall take into account 50 percent of the WIN expenses incurred with respect to the employee hired on September 1, C and D shall each take into account 25 percent of the WIN expenses incurred with respect to the employees employed by the partnership in 1972. Under paragraph (a)(3), for purposes of determining the period of employment that may be taken into account by B, the initial date of employment of the WIN employee hired on January 1 relates back to the date he was first employed, *i.e.*, January 1, 1972.

Example (3). Partnership SH is engaged in manufacturing. Under the terms of the partnership agreements deductions attributable to the employment of WIN employees are specially allocated 70 percent to partner S and 30 percent to partner H. In all other respects S and H share profits and losses equally. If the special allocation with respect to the WIN expenses is recognized under section 704 (a) and (b) and paragraph (b) of § 1.704-1, the WIN expenses shall be taken into account, 70 percent by S and 30 percent by H.

Example (4). (i) LMN partnership, which files its return on the basis of the calendar year, hires five WIN employees in 1973. The WIN expenses incurred with respect to each employee are as follows:

WIN employee No.	WIN expenses
1	$6,000
2	5,000
3	4,000
4	4,000
5	3,000
Total	22,000

On December 31, 1973, the ratio in which the partners divide the general profits of the LMN partnership is as follows: L receives three-tenths of the general profits, M receives two-tenths of the general profits, and N receives five-tenths of the general profits.

(ii) Under this section the WIN expenses are apportioned to the partners of LMN partnership as follows:

WIN employees	1	2	3	4	5	Total
Total WIN expenses	$6,000	$5,000	$4,000	$4,000	$3,000	$22,000
Partner L (3/10)	1,800	1,500	1,200	1,200	900	6,600
Partner M (2/10)	1,200	1,000	800	800	600	4,400
Partner N (5/10)	3,000	2,500	2,000	2,000	1,500	11,000

Assume that partners L, M, and N did not directly incur any other WIN expenses during their taxable year in which falls December 31, 1973 (the last day of LMN partnership's taxable year) and that such partners did not own any interest in other partnerships, electing small business corporations, estates, or trusts that incurred WIN expenses. The total WIN expenses of partner L are $6,600, of partner M are $4,400, and of partner N are $11,000.

[38 FR 6164, Mar. 7, 1973]

§ 1.50B–5 Limitations with respect to certain persons.

(a) *Mutual savings institutions.* In the case of an organization to which

section 593 applies (that is, a mutual savings bank, a cooperative bank, or a domestic building and loan association)—

(1) WIN expenses shall be 50 percent of the amount otherwise determined under paragraph (a) of § 1.50B–1, and

(2) The $25,000 amount specified in section 50A(a)(2), relating to limitation based on amount of tax, shall be reduced by 50 percent of such amount.

For example, a domestic building and loan association incurs $30,000 in WIN expenses (as determined under paragraph (a) of § 1.50B–1) during its taxable year. However, under this paragraph such amount is reduced to $15,000 (50 percent of $30,000). If an organization to which section 593 applies is a member of a controlled group (as defined in section 50A(a)(5)), the $25,000 amount specified in section 50A(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of § 1.50A–1 before such amount is further reduced under this paragraph.

(b) *Regulated investment companies and real estate investment trusts.* (1) In the case of a regulated investment company or a real estate investment trust subject to taxation under subchapter M, chapter 1 of the Code—

(i) The WIN expenses determined under paragraph (a) of § 1.50B–1, and

(ii) The $25,000 amount specified in section 50A(a)(2), relating to limitation based on amount of tax,

shall be reduced to such person's ratable share of each such amount. If a regulated investment company or a real estate investment trust is a member of a controlled group (as defined in section 50A (a)(5)), the $25,000 amount specified in section 50A(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of § 1.50A–1 before such amount is further reduced under this paragraph.

(2) A person's ratable share of the amount described in subparagraph (1)(i) and the amount described in subparagraph (1)(ii) of this paragraph shall be the ratio which—

(i) Taxable income for the taxable year, bears to,

(ii) Taxable income for the taxable year plus the amount of the deduction for dividends paid taken into account under section 852(b)(2)(D) in computing investment company taxable income, or under section 857(b)(2)(B) (section 857(b)(2)(C), an then in effect, for taxable years ending before October 5, 1976) in computing real estate investment trust taxable income, as the case may be.

For purposes of the preceding sentence, the term "taxable income" means, in the case of a regulated investment company, its investment company taxable income (within the meaning of section 852(b)(2)) and, in the case of a real estate investment trust its real estate investment trust, taxable income (within the meaning of section 857(b)(2)). In the case of a taxable year ending after October 4, 1976, real estate investment trust taxable income, for purposes of this paragraph, is determined by excluding any net capital gain, and by computing the deduction for dividends paid without regard to capital gains dividends (as defined in section 857(b)(3)(C)). In the case of a real estate investment trust, the amount of the deduction for dividends paid includes the amount of deficiency dividends (other than capital gains deficiency dividends) taken into account in computing real estate investment trust taxable income for the taxable year. See section 859(d) for the definition of deficiency dividends.

(3) This paragraph may be illustrated by the following example:

Example. (i) Corporation X, a regulated investment company subject to taxation under section 852 of the Code, which makes its return on the basis of the calendar year, incurs WIN expenses of $30,000 during the year 1974. Corporation X's investment company taxable income under section 852 (b)(2) is $10,000 after taking into account a deduction for dividends paid of $90,000.

(ii) Under this paragraph, Corporation X's WIN expenses for the taxable year 1974 is $3,000, computed as follows: (*a*) $30,000 (WIN expenses), multiplied by (*b*) $10,000 (taxable income), divided by (*c*) $100,000 (taxable income plus the deduction for dividends paid). For 1974, the $25,000 amount specified in section 50A(a)(2) is reduced to $2,500.

(c) *Cooperatives.* (1) In the case of a cooperative organization described in section 1381(a)—

(i) The WIN expenses determined under paragraph (a) of § 1.50B–1, and

(ii) The $25,000 amount specified in section 50A(a)(2), relating to limitation based on amount of tax,

shall be reduced to such cooperative's ratable share of each such amount (as determined under subparagraph (2) of this paragraph). If a cooperative organization described in section 1381(a) is a member of a controlled group (as defined in section 50A(a)(5)), the $25,000 amount specified in section 50A(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of § 1.50A-1 before such amount is further reduced under this paragraph.

(2) A cooperative's ratable share of the amount described in subparagraph (1)(i) and the amount described in subparagraph (1)(ii) of this paragraph shall be the ratio which—

(i) Taxable income for the taxable year, bears to

(ii) Taxable income for the taxable year plus the sum of (*a*) the amount of the deductions allowed under section 1382(b), and (*b*) the amount of the deductions allowed under section 1382(c), and (*c*) amounts similar to the amounts described in (*a*) and (*b*) of this subdivision the tax treatment of which is determined without regard to subchapter T, chapter 1 of the Code and the regulations thereunder.

(3) This paragraph may be illustrated by the following example:

Example. (i) Cooperative X, an organization described in section 1381(a) which makes its return on the basis of the calendar year, incurs WIN expenses of $30,000 for the taxable year 1972. Cooperative X's taxable income is $10,000 after taking into account deductions of $30,000 allowed under section 1382(b), and deductions of $60,000 allowed under section 1382(c).

(ii) Under this paragraph, Cooperative X's WIN expenses for the taxable year 1972 are $3,000, computed as follows: (*a*) $30,000 (WIN expenses), multiplied by (*b*) $10,000 (taxable income), divided by (*c*) $100,000 (taxable income plus the sum of deductions allowed under sections 1382(b) and 1382(c)). For 1972, the $25,000 amount specified in section 50A(a)(2) is reduced to $2,500.

[38 FR 6164, Mar. 7, 1973, as amended by T.D. 7767, 46 FR 11262, Feb. 6, 1981]

Tax Surcharge

§ 1.51-1 Imposition of surcharge.

(a) *Introduction*—(1) *Scope of section.* In addition to the other taxes imposed under chapter 1 of the Code, section 51 imposes a surcharge on the income of individuals, estates and trusts and corporations. The tax imposed by this section constitutes a Federal income tax. Thus, for example, for purposes of sections 275(a)(1), 535(b)(1), 545(b)(1), and 556(b)(1), the term "Federal income tax" used therein includes the proper amount of the surcharge.

(2) *Taxable years affected.* The surcharge is applicable with respect to taxpayers other than corporations for taxable years ending after March 31, 1968, and beginning before July 1, 1970, and with respect to corporations for taxable years ending after December 31, 1967, and beginning before July 1, 1970. For purposes of this section, the term, "effective date of the surcharge" for taxpayers other than corporations is April 1, 1968, and for corporations is January 1, 1968. Although the effective date for a taxpayer other than a corporation is April 1, 1968, the adjusted tax of a taxpayer whose taxable year ends after March 31, 1968, includes the tax (with certain adjustments described in paragraph (c) of this section) for the entire taxable year. For example, the adjusted tax of a taxpayer whose taxable year is the calendar year 1968, will include the tax on such taxpayer's taxable income for his entire calendar year 1968. The surcharge is not applicable with respect to a taxable year beginning after June 30, 1970.

(b) *Computation of surcharge for calendar years*—(1) *Individuals.* The surcharge imposed on individuals whose taxable year is the calendar year is determined in accordance with the applicable table contained in section 51(a)(1)(A).

(2) *Other persons.* The surcharge on the income of corporations and estates and trusts whose taxable year is the calendar year is determined in accordance with the table contained in section 51(a)(1)(B).

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(3) *Special rules for computation of surcharge.* A limitation on the amount of tax imposed by chapter 1 of the Code which is determined with reference to tax rates applicable to prior taxable years, as, for example, the limitations prescribed in sections 481, 668, 1341, 1342 and 1383, shall be applied after the computation of tax including the surcharge (determined without regard to such limitation). For example, under section 481(a) if an individual changes his method of accounting certain adjustments must be made to his income. However, an increase in tax as a result of such adjustment (the "basic" increase) is limited by section 481(b) to the increase that would have resulted if the adjustment had been spread out and added ratably to the taxable income over the year in question and the 2 preceding years. In such cases the basic increase under section 481(a) will be computed with the surcharge if the change in accounting is taken into account in a surcharge year. However, the limitation in section 481(b) will be computed as follows: The amount of tax on the income (including the ratable portion of the adjustment) in any surcharge year will be figured by taking the surcharge into account; however, the amount of tax on the incomes (including the ratable portion of the adjustment) in any nonsurcharge year will be figured only under regular rates (i.e., without the surcharge).

(4) *Illustration of principles.* The provisions of subparagraph (3) of this paragraph may be illustrated by the following examples:

Example. (a) A, an individual filing a joint return whose taxable year is a calendar year changed his method of accounting for the calendar year 1968. The change resulted in an adjustment under section 481(a) requiring a $6,000 increase in A's taxable income for 1968. Prior to the adjustment A's taxable income for 1968 was $20,000. In order to apply section 481(b)(1) it is determined that A's taxable income for 1967 and 1966 was $14,000 and $12,000 respectively, and A's tax liability for 1967 and 1966 was $2,760 and $2,260 respectively. Under section 481(a) taxable income is increased from $20,000 to $26,000. Assume the tax computed without regard to the surcharge on $20,000 is $4,380 and on $26,000 is $6,380. Assume that the amount of surcharge on an adjusted tax of $4,380 and $6,380 is $328.50 and $478.50, respectively.

(b) Under section 481(b)(1) A's 1968 tax attributable to the $6,000 increase in A's 1968 taxable income shall not be greater than the aggregate increase in taxes for 1968, 1967, and 1966 if $2,000 (⅓ of $6,000) were added to $20,000 taxable income for 1968, $14,000 taxable income for 1967 and $12,000 taxable income for 1966. Under subparagraph (3) of this paragraph, A's 1968 tax attributable to the $6,000 increase for purposes of applying section 481(b)(1) is determined after computation of the surcharge for 1968. A's 1968 tax (including surcharge) on $20,000 is $4,708.50 ($4,380 + 328.50); and on $26,000 is $6,858.50 ($6,380 + $478.50). Therefore, A's 1968 tax (including surcharge) attributable to such increase is $2,150 ($6,858.50 − $4,708.50).

(c) For purposes of applying section 481(b)(1) the aggregate increase in taxes (including surcharge) for 1968, 1967, and 1966 resulting from a $2,000 increase in the taxable income for each year is computed as follows:

	1968	1967	1966
(1) Taxable income before adjustment	$20,000.00	$14,000	$12,000
(2) Taxable income with adjustment (item (1) plus $2,000)	22,000.00	16,000	14,000
(3) Tax without surcharge after adjustment (tax on item (2))	5,020.00	3,260	2,760
(4) 1968 surcharge after adjustment (7.5% of line 3)	376.50		
(5) Tax with surcharge after adjustment (items (3) + (4))	5,396.50	3,260	2,760
(6) Tax (with surcharge included for 1968) before adjustment	4,708.50	2,760	2,260
(7) Increase in tax (with surcharge for 1968) attributable to adjustment (item (5) minus item (6))	688.00	500	500
(8) Total increase in taxes (including surcharge) for 1968, 1967, and 1966 ($688 + $500 + $500)		1,688	

(d) Since this increase in tax of $1,688 is less than the increase in tax attributable to the inclusion of the entire adjustment of $6,000 in A's 1968 taxable income ($2,150), the limitation provided by section 481(b)(1) applies and the total tax (including surcharge) for 1968 if section 481(b)(2) does not apply is determined as follows:

(1) Tax (including surcharge) on $20,000	4,708.50
(2) Increase as limited by section 481(b)(1)	1,688.00
(3) Total tax (including surcharge) for 1968	6,396.50

(c) *Adjusted tax*—(1) *In general.* The term "adjusted tax" means, with respect to any taxable year, the tax imposed by chapter 1 of the Code (other than the surcharge imposed by section 51) including the tax imposed by section 1201 (relating to the alternative tax for capital gains) for such taxable year, determined without regard to,

(i) The tax imposed by section 871(a) (relating to tax on income of nonresident aliens not connected with U.S. business),

(ii) The tax imposed by section 881 (relating to tax on income of foreign corporations not connected with U.S. business),

(iii) The tax imposed by section 56 (relating to minimum tax for tax preferences),

(iv) Any increase in tax under section 47(a) (relating to certain dispositions, etc., of section 38 property),

(v) Any increase in tax under section 614(c)(4)(C) (relating to special rules as to operating mineral interests in mines in connection with section 615(a) prior to aggregation), and

(vi) The limitations on tax referred to in paragraph (b)(3) of this section, and reduced as provided in subparagraph (2) of this subparagraph by the credit allowable under section 37 (relating to retirement income). In the computation of the adjusted tax, the alternative tax imposed by section 1201 is determined and included in adjusted tax without taking the surcharge into account. Similarly, the alternative tax determined under sections 594, 802(a)(2), 821(c), and 1304(e)(2) shall be included in adjusted tax, without taking the surcharge into account in such computation. In computing the surcharge, the surcharge percentage contained in the applicable tables is applied against the entire amount of adjusted tax, including the amount attributable to the alternative tax.

(2) *Application of tax credits.* Under section 51 adjusted tax is determined before all credits against tax, except the retirement income credit under section 37. In making the computation of the retirement income credit for purposes only of determining adjusted tax, the limitation contained in section 37(a) is determined without taking the surcharge into account. After the determination of the adjusted tax, the taxpayer's total tax liability, including the surcharge, may be offset by credits to which the taxpayer is entitled, including the retirement income credit (determined after taking the surcharge into account). In the determination of other credits similarly limited by the amount of tax imposed under chapter 1 of the Code, as, for example, the credit allowed under section 46, relating to credits on investments in certain depreciable property, the amount of tax upon which such limitation is based shall include the tax surcharge.

(d) *Computation of tax surcharge for fiscal and short taxable years*—(1) *In general.* (i) The tax surcharge attributable to the fiscal year or short taxable year of a corporation or of an estate or trust, and, except as limited by subparagraph (4) of this paragraph, of any individual (other than an estate or trust), is determined in accordance with section 51(a)(2). Under section 51(a)(2) in the case of taxable years ending on or after the effective date of the surcharge (as defined in paragraph (a)(2) of this section) and beginning before July 1, 1970, the surcharge is determined by multiplying 10 percent of the adjusted tax for the taxable year by a fraction (hereinafter described as the proration fraction), the numerator of which is the sum of the number of days, if any, in the taxable year occurring on and after the effective date of the surcharge and before January 1, 1970, plus one-half times the number of days, if any, in the taxable year occurring after December 31, 1969, and before July 1, 1970, and the denominator of which is the number of days in the entire taxable year. Section 21, relating to computation of tax in years where there is a change in rates, is not applicable to the increase in tax attributable to the surcharge.

(ii) The following examples illustrate the application of subdivision (i) of this subparagraph:

Example (1). A, a single individual (other than a surviving spouse or head of household) reports his income on a July 1

through June 30 fiscal year. For the period of July 1, 1967, through June 30, 1968, A's adjusted tax is $36,600. Since A's taxable year is a fiscal year, A computes his tax surcharge by use of the proration fraction. Therefore, A's tax surcharge for fiscal year 1968 is $910 determined by multiplying $3,660 (10 percent of $36,600) by a fraction, the numerator of which is 91 (the number of days in the taxable year occurring on and after April 1, 1968, the effective date of the surcharge for individuals, and before January 1, 1970) and the denominator of which is 366 (the number of days in his entire taxable year)

($3,660 × 91 ÷ 366).

Example (2). Assume the same facts in example (1) except that the facts are with respect to A's fiscal year ending June 30, 1969. Since the entire fiscal year begins after the effective date of the surcharge (Apr. 1, 1968) and is before January 1, 1970, A's surcharge is $3,660 (10 percent of $36,600).

Example (3). B, a single individual (other than a surviving spouse or head of household) reports his income on a July 1 through June 30 fiscal year. For the period of July 1, 1969 through June 30, 1970, B's adjusted tax is $36,500. Since B's taxable year is a fiscal year, B computes his tax surcharge by use of the proration fraction, the numerator of which is 274.5, which is the sum of 184, the number of days in the taxable year occurring after April 1, 1968, and before January 1, 1970; and one-half of 181, the number of days in the taxable year occurring after December 31, 1969 and before July 1, 1970

(184 + 181 ÷ 2).

Therefore, B's tax surcharge for the fiscal year ending in 1970 is $2,745, determined by multiplying $3,650 (10 percent of $36,500) by a fraction, the numerator of which is 274.5 and the denominator of which is 365 (the number of days in B's entire taxable year)

($3,650 × 274.5 ÷ 365)

(2) *Short taxable year because of death of spouse.* If a husband and wife have different taxable years solely because of the death of a spouse, and both would have had the calendar year or the same fiscal year as the taxable year but for such death, and if a joint return is filed with respect to the taxable years of each, then for purposes of the computation of the tax surcharge on the joint return the taxable years of both spouses shall be treated as the calendar year, or the fiscal year, as the case may be. In such a case the rules contained in section 6013(c), relating to the treatment of a joint return after the death of either spouse, shall apply. Accordingly, if H dies on August 30, 1968, and a joint return is filed on April 15, 1969, for the short taxable year of H, January 1 through August 30, and the calendar year of his wife, W, their surcharge will be computed in the manner prescribed in Table 3, section 51(a)(1)(A), based upon W's calendar year.

(3) *Short taxable year due to changes of accounting period.* (i) In the case of a return for a short period due to change of annual accounting period, the computation under section 443(b)(1) shall be made to determine the adjusted tax and not to determine the surcharge. In such case, the proration fraction prescribed in section 51(a)(2) is applicable after the determination of tax (without regard to the surcharge) for the short period under section 443(b). Therefore, if the taxpayer elects to utilize the exception provided in paragraph (2) of section 443(b), the greater of the amount under clause (i) or (ii) of subparagraph (A) of such paragraph is determined without taking the surcharge into account, and such amount is then used as a basis for determining the adjusted tax for purposes of computing the surcharge.

(ii) The application of this subparagraph is illustrated by the following example:

Example. (a) A and B, individuals filing a joint return, have been granted permission under section 442 to change their annual accounting period. They file a return for the short period of 7 months ending May 31, 1968. Assume that A and B have properly annualized their taxable income and credits for the short period (Nov. 1, 1967, through May 31, 1968) and such annualized taxable income and credits is as follows:

Taxable income	$12,000
Retirement income credit	340
Other allowable credits	1,200

(b) A and B's tax before surcharge is as follows:

Tax on $12,000	$2,260
Less: Retirement income	

Credit	$340	
Other credits	1,200	1,540
Tax for annualized period		720
Tax for 7 month period (7/12 × $720)		420

(c) A and B's tax surcharge is computed as follows:

Tax determined under section 443	$420.00
Add: Credits other than retirement income credit (7/12 × $1,200)	700.00
Adjusted tax	1,120.00
Tax Surcharge (61/213 × 10% × $1,120)	32.08
(d) A and B's total tax ($420 + 32.08)	452.08

(4) *Limitation on surcharge attributable to individuals with fiscal or short taxable years.* With respect to individuals with fiscal or short taxable years—

(i) *Joint return.* In the case of a husband and wife (or surviving spouse) who file a joint return under section 6013 and whose adjusted tax for the taxable year is less than $580, the surcharge shall not exceed twice the surcharge which would be determined under section 51(a)(2)(A) if the surcharge were imposed on the amount by which the adjusted tax exceeds $290.

(ii) *Head of household.* In the case of an individual who is a head of household to whom section 1(b) applies and whose adjusted tax for the taxable year is less than $440, the surcharge shall not exceed twice the surcharge which would be determined under section 51(a)(2)(A) if the surcharge were imposed on the amount by which the adjusted tax exceeds $220.

(iii) *Other individuals.* In the case of an individual other than an individual referred to in subdivision (i) or (ii) of this subparagraph (but not including an estate or trust) whose adjusted tax for the taxable year is less than $290, the surcharge shall not exceed twice the surcharge which would be determined under section 51(a)(2)(A) if the surcharge were imposed on the amount by which the adjusted tax exceeds $145.

(iv) *Illustration.* The provisions of this subparagraph may be illustrated by the following example:

Example: A and B file a joint return for the fiscal year July 1, 1967, through June 30, 1968. Their adjusted tax is $500. Since their adjusted tax is less than $580, the amount of the surcharge is limited as provided in subdivision (i) of this subparagraph. The limitation is computed as follows:

Adjusted tax	$500.00
Less: Limitation amount for taxpayers filing joint returns	290.00
Balance against which twice the surcharge rate is applied	210.00
Amount of surcharge before limitation ($500 × 10% × 91 ÷ 366)	12.43
Amount of surcharge as limited ($210 × 10% × 91 ÷ 366 × 2)	10.44

(e) *Western Hemisphere trade corporations and dividends on certain stock.* (1) Section 244(a)(2) (relating to deductions with respect to dividends received on the preferred stock of a public utility), section 247(a)(2) (relating to deduction with respect to certain dividends paid by a public utility) and section 922(2) (relating to special deduction for Western Hemisphere trade corporations) provide deductions which are computed, in part, by multiplying the dividends received or paid in the case of sections 244(a)(2) and 247(a)(2), and taxable income in the case of section 922(2), by a fraction, the numerator of which is 14 percent, and the denominator of which is that percentage which equals the sum of the normal tax rate prescribed in section 11(b) and the surtax rate prescribed in section 11(c), for the taxable year, for example, 48 percent for 1968 and 1969. In order to reflect the imposition of the tax surcharge in the determination of these deductions, section 51(d) provides that the denominator of such fractions must be increased to reflect the rate at which the surcharge is imposed. Under this provision, in the case of a corporation whose taxable year is a calendar year, the denominator is increased from 48 percent to 52.8 percent for 1968 and 1969, and from 48 percent to 49.2 percent for 1970. In the case of a corporation whose taxable year is other than a calendar year, the fraction prescribed in each section is adjusted by adding to the denominator of such fraction the product of 4.8 percent (10 percent of 48 percent) multiplied by a surcharge proration fraction, the numerator of which is the sum of the number of days, if any, in the taxable year occurring on and after January 1,

1968, and before January 1, 1970, plus one-half times the number of days, if any, in the taxable year occurring after December 31, 1969 and before July 1, 1970, and the denominator of which is the number of days in the entire taxable year.

(2) The application of this paragraph is illustrated by the following examples:

Example (1). A, a calendar year corporation eligible for the deduction under section 244 (relating to dividends received on certain preferred stock), receives dividends in 1968 of $10,000 from Corporation B, a public utility corporation which is subject to taxation under chapter 1 of the Code, and with respect to which the deduction provided under section 247 is allowable with respect to these dividends. The deduction allowable under section 244 for the calendar year 1968 with respect to these dividends is $6,246.21, computed as follows:

Dividends received on preferred stock	$10,000.00
Less: The product of such dividends and the fraction specified in section 244(a)(2) adjusted to reflect surcharge ($10,000 × 14/52.8)	2,651.52
Amount subject to 85 percent deduction	7,348.48
Deduction allowable under section 244 (85 percent of $7,348.48)	6,246.21

Example (2). (a) Corporation W which qualifies as a Western Hemisphere trade corporation has taxable income for the fiscal year February 1, 1967, through January 31, 1968 (without taking the special deduction allowed under section 922 into account) of $176,688. The number of days in W's taxable year occurring on and after January 1, 1968, is 31. The number of days in the entire taxable year is 365.

(b) The denominator of the fraction referred to in section 922(2) used in computing the special deduction is increased from 48 percent to 48.40767 percent, computed as follows:

	Percent
Product of 4.8 percent and surcharge proration fraction (4.8% of 31/365)	0.40767
Sum of 48 percent and product (48% + 0.40767%)	48.40767

(c) Corporation W's special deduction under section 922 is $51,100, which is the product of W's taxable income (computed without the deduction) ($176,688) and the fraction referred to in section 922(2) adjusted to reflect the surcharge (14%/48.40767%) computed as follows:

(14%) × ($176,688) ÷ (48.40767%) = $51,100.

(f) *Shareholders of regulated investment companies*—(1) *In general.* Section 852 requires, generally, that shareholders of regulated investment companies include in their income their designated share of undistributed long-term capital gain. Under section 852(b)(3)(D)(ii) a shareholder is deemed to have paid his share of the tax required to be paid by the company under section 852(b)(3)(A) on such gain. Prior to the amendment of section 852 by the Tax Reform Act of 1969, which amendments were effective for taxable years beginning after December 31, 1969, section 852(b)(3)(A) expressly referred to a 25 percentage figure. For taxable years beginning after December 31, 1969, section 852(b)(3)(A), as amended by the Act, no longer refers to a specific percentage figure. Under section 852(b)(3)(D)(iii) the basis of the shareholder's shares is correspondingly increased with respect to his share of the capital gain on which he is deemed to have paid tax.

(2) *Adjustment for calendar year company*—(i) *Calendar years 1968 and 1969.* In the case of a regulated investment company whose taxable year is a calendar year, the tax of 25 percent deemed paid, under former section 852(b)(3)(D)(ii), by a shareholder of a regulated investment company is increased by 2.5 percent (10 percent of 25 percent) from 25 percent to 27.5 percent. A corresponding adjustment must also be made in the percentage figure used to increase adjusted basis of the shares of the regulated investment company in the hands of the shareholder. Therefore, the applicable percentage figure is decreased from 75 percent to 72.5 percent (75 percent less 2.5 percent).

(ii) *Calendar year 1970.* The taxes deemed paid by a shareholder of a regulated investment company under section 852(b)(3)(D)(ii) include the surcharge. This has the effect of increasing the percentage figures of 25 percent and 28 percent, referred to in section 1201(a), to, respectively, 25.625 percent (25 percent plus .625 percent (the product of 2.5 percent of 25 percent)) and 28.7 percent (28 percent plus 0.7 percent (the product of 2.5 percent of 28 percent)). A correspond-

ing adjustment for 1970 must also be made in the percentage figures prescribed under section 852(b)(3)(D)(iii) used to increase adjusted basis of the shares of the shareholder. Therefore, the percentages applicable in section 852(b) (3)(D)(iii) are decreased from 75 percent to 74.375 percent (75 percent less 0.625 percent (the product of 2.5 percent of 25 percent)) and from 72 percent to 71.3 percent (72 percent less 0.7 percent (the product of 2.5 percent of 28 percent)) for calendar year 1970.

(3) *Adjustment for a fiscal or short taxable year*—(i) *Taxable years ending prior to January 1, 1970.* In the case of a corporation with a taxable year which is other than a calendar year and which ends prior to January 1, 1970, the tax of 25 percent deemed paid by a shareholder of a regulated investment company is increased by the product of 2.5 percent (10 percent of 25 percent) times a surcharge proration fraction, the numerator of which is the sum of the number of days in the taxable year of the regulated investment company occurring on and after January 1, 1968, and the denominator of which is the number of days in the entire taxable year. The percentage figure of 75 percent used to increase adjusted basis of the shares of the regulated investment company in the hands of the shareholder is correspondingly decreased.

(ii) *Taxable years ending after December 31, 1969.* In the case of taxable years, other than the calendar year, beginning in 1969 and ending in 1970, in applying section 852(b)(3)(D)(ii) each shareholder shall be deemed to have paid a tax on certain capital gains imposed upon the investment company by section 852(b)(3)(A) which amount shall include the amount of surcharge attributable thereto. Since the rate of tax under section 852(b)(3)(A) (without regard to the surcharge) has changed, with the effective date of change being January 1, 1970, the rules of section 21 (relating to the effect of such changes) shall be applied in computing the adjusted tax of the company. After the adjusted tax is so computed, the surcharge attributable thereto shall be determined under section 51(a)(2)(A) of the Code and paragraph (d) of this section. Similarly, a corresponding adjustment to the basis under section 852(b)(3)(D)(iii) shall be made.

(iii) Subdivisions (i) and (ii) of this subparagraph may be illustrated by the following examples. Assume that all computations are carried out to sufficient accuracy:

Example (1). (a) R, a regulated investment company as defined in section 851, has a fiscal taxable year from April 1, 1967, through March 31, 1968. The number of days in R's taxable year occurring on or after January 1, 1968, is 91. The number of days in the entire taxable year is 366.

(b) The percentage figure (25 percent before adjustment) referred to in former section 852(b)(3)(A) and, by cross reference, in section 852(b)(3)(D)(ii) applicable to R must be increased to 25.622 percent, computed as follows:

$$(2.5\%)\times(91)\div 366+25\%=25.622\%$$

(c) The percentage figure (75 percent prior to adjustment) referred to in former section 852(b)(3)(D)(iii) must be decreased to 74.378 percent, computed as follows:

$$75\%-(2.5\%)\times(91)\div 366=74.378\%$$

Example (2). (a) R, a regulated investment company as defined in section 851, has a fiscal taxable year from July 1, 1969, through June 30, 1970. The amount of undistributed long-term capital gains, during such taxable year of R, is $55,000. There are no short-term capital losses and no deductions for dividends paid (as defined in section 561). The total amount of undistributed subsection (d) gain (as defined in section 1201(d)) is $50,000. The number of days in R's taxable year occurring before January 1, 1970, is 184. The number of days in R's taxable year occurring after December 31, 1969, is 181. One-half of the number of days in R's taxable year occurring after December 31, 1969, and before July 1, 1970, is 90.5. The total number of days in R's taxable year is 365.

(b) Adjusted tax is $13,824.39, computed as follows:

(1) First tentative tax is $6,931.51

$$(25\%\times\$55{,}000)\times 184\div 365).$$

(2) Second tentative tax is $6,892.88

$$([(25\%\times\$50{,}000)+(28\%\times\$5{,}000)]\times 181\div 365).$$

(3) The sum of first tentative tax and second tentative tax is $13,824.39 ($6,931.51 + $6,892.88).

(c) The amount of surcharge is $1,039.67, computed as follows:

(10% × $13,824.39) × 184 ÷ 90.5 ÷ 365 = $1,039.67

(g) *Determinations of subtractions from policyholders surplus account of life insurance company.* Section 815(c)(3)(B) provides that there shall be subtracted from the policyholder's surplus account the amount (determined without regard to section 802(a)(3)) by which the tax imposed for the taxable year by section 802(a) is increased by reason of section 802(b)(3). Section 1.815-4 provides a formula to be used to determine the amount of the subtraction referred to in section 815(c)(3). In order to take the surcharge into account the numerator (referred to in § 1.815-4(c)(2)(iii)(*b*)) and the denominators contained in such formulas shall be decreased to reflect the surcharge percentage. For example, § 1.815-4(c)(2)(i), which applies, in general, when a company's life insurance company taxable income exceeds $25,000, provides that the amount subtracted from the policyholders surplus account shall be determined by multiplying the amount treated as distributed out of such account by a ratio, the numerator of which is 100 percent and the denominator of which is 100 percent minus the sum of the normal tax rate and the surtax rate for the taxable year. In order to reflect the imposition of the surcharge, the denominator of the fraction must be decreased from 52 percent (100 percent−48 percent) to 47.2 percent (100 percent−(48 percent+4.8 percent)) for 1968 and 1969. For 1970, the denominator must be decreased from 52 percent to 49.2 percent (100 percent−(48 percent+1.2 percent)).

(h) *Special rule for application of surcharge*— (1) *General rule.* Except as otherwise provided in this section, to the extent the tax imposed by section 51 is attributable to a tax imposed by another section of chapter 1 of the Code, such tax shall be deemed to be imposed by such other section. For example, if the only tax (other than the surcharge) imposed under chapter 1 of the Code to which a particular corporation is subject is the tax imposed by section 11, then the surcharge imposed on such corporation shall be deemed to be imposed by section 11. However, in computing the adjusted tax under section 51(b) and paragraph (c) of this section, the taxes imposed shall be determined without regard to any amount of the surcharge, whether or not deemed imposed by a section other than section 51 by operation of this paragraph. If an amount of surcharge is deemed imposed by a section other than section 51 by application of this paragraph, this paragraph shall not be applied again with respect to the same amount of surcharge. Thus, for example, if a life insurance company is subject to the tax imposed by section 802, the rates of which are determined with reference to section 11, the surcharge attributable to such tax shall be deemed to be imposed by section 802 and not by section 11. Therefore, in applying section 815(c)(3)(B), relating to certain subtractions of amounts of tax from policyholders surplus account of a stock life insurance company, the term "tax imposed for the taxable year by section 802(a)" includes the amount of surcharge attributable thereto. (See paragraph (g) of this section for special rules for determining such term.)

(2) *Illustrations of general rule.* The application of the rules contained in subparagraph (1) of this paragraph is illustrated as follows:

(i) In general, under section 46(a) the amount of credit for investment in certain depreciable property is limited to an amount equal to a specified amount of tax other than the tax imposed by certain designated sections (such as section 531, relating to the accumulated earnings tax). Under subparagraph (1) of this paragraph, only the amount of the surcharge attributable to the tax imposed by sections other than the designated sections may be taken into account in computing the limitation on the credit under section 46.

(ii) In general, under section 72(n)(3) (relating to determination of taxable income by certain self-employed individuals) any increase in taxes imposed by section 1 or 3 by reason of section 72(n)(3) shall not be reduced by any credit under part IV of subchapter A (other than sections 31 and 39 thereof). Under the rules prescribed in subparagraph (1) of this paragraph, such

resulting increase in taxes shall be deemed to include the proper amount of the surcharge, and accordingly, such amount of surcharge shall not be reduced by such credits.

(iii) In general, under section 1372(b)(1) if a small business corporation makes an election under section 1372(a), such corporation shall not be subject to the taxes imposed by chapter 1 of the Code other than the tax imposed by section 1378. Under the rules prescribed in subparagraph (1) of this paragraph, such corporation shall be deemed to be subject to the surcharge imposed by section 51 attributable to the tax imposed by section 1378.

(i) *Payment of surcharge*—(1) *In general.* (i) Except as provided in subdivision (ii) of this subparagraph, the surcharge is due and payable at the same time as the income tax imposed by Chapter 1 of the Code.

(ii) In the case of a taxable year ending before June 28, 1968, the time prescribed for payment of the surcharge shall be on September 16, 1968. If a corporation elects, under section 6152, to pay its tax in two equal installments and both installments are due before September 16, 1968, then the entire additional payment required to reflect the surcharge must be paid on or before September 16. If the first installment is due on or before September 16, but the second installment is due after that date, the corporation must pay one-half of the amount of the surcharge on or before September 16, 1968. The remaining one-half of the surcharge due must be paid as a part of the second installment on the due date for that installment. A taxpayer whose taxable year ended before June 28, 1968, and filed his return before September 16, 1968, without including the tax imposed by section 51 is required to file an amended return (or an amended fiscal year tax computation schedule) by September 16, 1968 to reflect the amount of his tax surcharge. Since an amended return (or an amended fiscal year tax computation schedule) does not constitute a return for purposes of determining the periods of limitation under section 6501 or 6511 of the Code, neither the period of limitation on assessment and collection nor the period of limitation on credit or refund, if otherwise measured from the time the return is filed, will be extended by the subsequent filing of such amended return or schedule.

(2) *Interest on underpayments.* Under section 6601 interest on an underpayment of the surcharge due on or before September 16, 1968, will be computed from such date. However, for purposes of computing interest on an underpayment of any tax, if the due date for payment of such tax (other than the surcharge) is before September 16, 1968, and if such tax is for a period, or a portion of a period, during which the surcharge applies, a payment before September 16, 1968, whether or not designated a payment of the surcharge, is applied against the underpayment of such tax to the extent thereof, and the balance, if any, is applied against any surcharge liability due on or before September 16, 1968.

(3) *Interest on overpayments.* Under sections 6611 and 6513, in general, interest on an overpayment of surcharge made before September 16, 1968, will be computed from such date. In the case of an overpayment of tax (not including surcharge) for a due date which is before the September 16, 1968, due date to the extent not designated a payment of surcharge, interest on such overpayment shall begin as of the prior due date (or payment, whichever is later) even if an amount of overpayment is subsequently credited against a subsequent tax liability (including a surcharge liability) on or after September 16, 1968. For purposes of this subparagraph an amount is treated as a payment of surcharge to the extent the payment exceeds the amount of tax computed without regard to the surcharge as shown on the return or amended return, and to the extent the payment does not exceed the amount reported on the return as surcharge.

[T.D. 7100, 36 FR 5328, Mar. 20, 1971; 36 FR 6081, Apr. 2, 1971]

§ 1.52-1 Trades or businesses that are under common control.

(a) *Apportionment of new jobs credit among members of a group of trades or businesses that are under common control*—(1) *General rule.* In the case of a group of trades or businesses that are under common control at any time during the calendar year, the amount of the new jobs credit (computed under section 51 as if all the organizations that are under common control are one trade or business) must be apportioned among the members of the group on the basis of each member's proportionate contribution to the increase in unemployment insurance wages of the entire group. The limitations in section 53 apply to each organization individually (although, in applying these limitations, an affiliated group of corporations electing to make a consolidated return shall be treated as one organization).

(2) *Example.* Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. (a) A Company and its three subsidiaries, B, C, and D Companies, are a group of businesses that are under common control. A, B, C, and D have paid out the following amounts in unemployment insurance wages during 1976 and 1977:

	1976	1977	Increase in FUTA wages in 1977 over 1976
A company	$1,000,000	$1,015,000	+$15,000
B company	500,000	650,000	+150,000
C company	600,000	580,000	−20,000
D company	40,000	100,000	+60,000
Total	2,140,000	2,345,000	+205,000

(b) Since all employees of trades or businesses that are under common control are treated as employed by a single employer, the computations in section 51 are performed as if all the organizations which are under common control are one trade or business. Consequently, the amounts of the total unemployment insurance wages of the group in 1976 (i.e., $2,140,000) and 1977 (i.e., $2,345,000) are used to determine the increase in unemployment insurance wages in 1977 over the 1976 wage base. Since the amount equal to 102 percent of the 1976 unemployment insurance wages ($2,182,800) is greater than the amount equal to 50 percent of the 1977 unemployment insurance wages ($1,172,500), the increase in unemployment insurance wages in 1977 over the 1976 wage base is $162,200 ($2,345,000 − $2,182,800). The limitations in section 51(c), (d), and (g) must also be computed as though all the organizations under common control are one trade or business. For purposes of this example, it is assumed that none of those limitations reduce the amount of the increase in unemployment insurance wages. As a result, the amount of the new jobs credit allowed to the group of businesses is $81,100 (50% of $162,200).

(c) The credit is apportioned among A, B, and D Companies on the basis of their proportionate contributions to the increase in unemployment insurance wages. No credit would be allowed to C Company because it did not contribute to the increase in the group's unemployment insurance wages. A Company's share of the credit would be $5,406.66 ($81,100 × ($15,000 ÷ $225,000 (i.e., $15,000 + $150,000 + $60,000))), B Company's share would be $54,066.67 ($81,100 × ($150,000 ÷ $225,000)), and D Company's share would be $21,626.67 ($81,100 × ($60,000 ÷ $225,000)).

(b) *Trades or businesses that are under common control.* For purposes of this section, the term "trades or businesses that are under common control" means any group of trades or businesses that is either a "parent-subsidiary group under common control" as defined in paragraph (c) of this section, a "brother-sister group under common control" as defined in paragraph (d) of this section, or a "combined group under common control" as defined in paragraph (e) of this section. For purposes of this section and §§ 1.52-2 and 1.52-3, the term "organization" means a sole proprietorship, a partnership, a trust, an estate, or a corporation. An organization may be a member of only one group of trades or businesses under common control. If, without the application of this paragraph, an organization would be a member of more than one such group, that organization shall indicate in its timely filed return the group in which it is being included. If the organization does not so indicate, then the district director with audit jurisdiction of the organization's return will determine the group in which the organization is to be included.

(c) *Parent-subsidiary group under common control*—(1) *In general.* The term "parent-subsidiary group under

common control" means one or more chains of organizations conducting trades or businesses that are connected through ownership of a controlling interest with a common parent organization if—

(i) A controlling interest in each of the organizations, except the common parent organization, is owned (directly and with the application of § 11.414(c)-4(b)(1), relating to options) by one or more of the other organizations; and

(ii) The common parent organization owns (directly and with the application of § 11.414(c)-4(b)(1), relating to options) a controlling interest in at least one of the other organizations, excluding, in computing the controlling interest, any direct ownership interest by the other organizations.

(2) *Controlling interest defined.* For purposes of this paragraph, the term "controlling interest" means:

(i) In the case of a corporation, ownership of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of the shares of all classes of stock of the corporation;

(ii) In the case of a trust or estate, ownership of an actuarial interest (determined under paragraph (f) of this section) of more than 50 percent of the trust or estate;

(iii) In the case of a partnership, ownership of more than 50 percent of the profit interest or capital interest of the partnership; and

(iv) In the case of a sole proprietorship, ownership of the sole proprietorship.

(d) *Brother-sister group under common control*—(1) *In general.* The term "brother-sister group under common control" means two or more organizations conducting trades or businesses if—

(i) The same five or fewer persons who are individuals, estates, or trusts own (directly and with the application of § 11.414(c)-4), singly or in combination, a controlling interest of each organization; and

(ii) Taking into account the ownership of each person only to the extent that person's ownership is identical with respect to each organization, such persons are in effective control of each organization.

(2) *Controlling interest defined.* For purposes of this paragraph, the term "controlling interest" means:

(i) In the case of a corporation, ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of the shares of all classes of stock of the corporation;

(ii) In case of a trust or estate, ownership of an actuarial interest (determined under paragraph (f) of this section) of a least 80 percent of the trust or estate;

(iii) In the case of a partnership, ownership of at least 80 percent of the profit interest or capital interest of the partnership; and

(iv) In the case of a sole proprietorship, ownership of the sole proprietorship.

(3) *Effective control defined.* For purposes of this paragraph "effective control" means:

(i) In the case of a corporation, ownership of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of the shares of all classes of stock of the corporation;

(ii) In the case of a trust or estate, ownership of an actuarial interest (determined under paragraph (f) of this section) of more than 50 percent of the trust or estate;

(iii) In the case of a partnership, ownership of more than 50 percent of the profit interest or capital interest of the partnership; and

(iv) In the case of a sole proprietorship, ownership of the sole proprietorship.

(e) *Combined group under common control.* The term "combined group under common control" means a group of three or more organizations, in which (1) each organization is a member of either a parent-subsidiary group under common control or brother-sister group under common control, and (2) at least one organization is the common parent organization of a parent-subsidiary group under common control and also a member of

a brother-sister group under common control.

(f) *Actuarial interest.* For purposes of this section, the actuarial interest of each beneficiary of a trust or estate shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of the beneficiary. The factors and method prescribed in § 20.2031-10 of this chapter (Estate Tax Regulations) for use in ascertaining the value of an interest in property for estate tax purposes will be used to determine a beneficiary's actuarial interest.

(g) *Exclusion of certain interests and stock in determining control.* In determining control under this paragraph, the term "interest" and the term "stock" do not include an interest that is treated as not outstanding under § 11.414(c)-3. In addition, the term "stock" does not include treasury stock or nonvoting stock that is limited and preferred regarding dividends.

[T.D. 7553, 43 FR 31322, July 21, 1978]

§ 1.52-2 Adjustments for acquisitions and dispositions.

(a) *General rule.* If, after December 31, 1975, an employer acquires the major portion of a trade or business or the major portion of a separate unit of a trade or business, then, for purposes of computing the credit for any calendar year ending after the acquisition, both the amount of unemployment insurance wages and the amount of total wages considered to have been paid by the acquiring employer, for both the year in which the acquisition occurred and the preceding year, must be increased, respectively, by the amount of unemployment insurance wages and the amount of total wages paid by the predecessor employer that are attributable to the acquired portion of the trade or business or separate unit. If the predecessor employer informs the acquiring employer in writing of the amount of unemployment insurance wages and the amount of total wages attributable to the acquired portion of the trade or business that have been paid during the periods preceding the aquisition, then, for purposes of computing the credit for any calendar year ending after the acquisition, the amount of unemployment insurance wages and the amount of total wages considered paid by the predecessor employer shall be decreased by those amounts. Regardless of whether the predecessor employer so informs the acquiring employer, the predecessor employer shall not be allowed a credit for the amount of any increase in the unemployment insurance wages or the total wages in the calendar year of the acquisition attributable to the acquired portion of the trade or business over the amount of such wages in the calendar year preceding the acquisition.

(b) *Meaning of terms*—(1) *Acquisition.* (i) For the purposes of this section, the term "acquisition" includes a lease agreement if the effect of the lease is to transfer the major portion of the trade or business or of a separate unit of the trade or business for the period of the lease. For instance, if one company leases a factory (including equipment) to another company for a 2-year period, the employees are retained by the second company, and the factory is used for the same general purposes as before, then for purposes of this section the lessee has acquired the lessor's trade or business for the period of the lease.

(ii) Neither the major portion of a trade or business nor the major portion of a separate unit of a trade or business is acquired merely by acquiring physical assets. The acquisition must transfer a viable trade or business.

(iii) Subdivision (ii) of this subparagraph may be illustrated by the following examples:

Example (1). R Co., a restaurant, sells its building and all its restaurant equipment to S Co. and moves into a larger, more modern building across the street. R Co. purchases new equipment, retains its name and continues to operate as a restaurant. S Co. opens a new restaurant in the old R Co. building. S Co. has merely acquired the old R Co. assets; it has not acquired any portion of R Co.'s business.

Example (2). The facts are the same as in *Example (1),* except that R Co. also sells its name and goodwill to S Co. and ceases to operate a restaurant business. S Co. operates its restaurant using the old R Co. name. In this situation, S Co. has acquired R Co.'s business.

(2) *Separate unit.* (i) A separate unit is a segment of a trade or business capable of operating as a self-sustaining enterprise with minor adjustments. The allocation of a portion of the goodwill of a trade or business to one of its segments is a strong indication that that segment is a separate unit.

(ii) The following examples are illustrations of the acquisition of a separate unit of a trade or business:

Example (1). The M Corp., which has been engaged in the sale and repair of boats, leases the repair shop building and all the property used in its boat repair operations to the N Co. for four years and gives the N Co. a covenant not to compete in the boat repair business for the period of the lease. The N Co. is considered to have acquired a separate unit of M Corp.'s business for the period of the lease.

Example (2). (a) the P Co. is engaged in the operation of a chain of department stores. There are eight divisions, each division is located in a different metropolitan area of the country, and each division operates under a different name. Although certain buying and merchandising functions are centralized, each division's day-to-day operations are independent of the others. The Q Corp. acquires all of the physical and intangible assets of one of the divisions, including the division's name. Other than making those minor adjustments necessary to give the division buying and merchandising departments, the Q Corp. allows the division to continue doing business in the same manner as it had been operating prior to the acquisition. The Q Corp. has acquired a separate unit of the P Co.'s business.

(b) The facts are the same as in (a) above, except that Q Corporation buys the division merely to obtain its store locations. Before the Q Corporation takes over, the division liquidates its inventory in a going-out-of-business sale. The Q Corporation has merely acquired assets in this transaction, not a separate unit of P Company's business.

Example (3). The R Company processes and distributes meat products. Both the processing division and the distributorship are self-sustaining, profitable operations. The acquisition of either the meat processing division or the distributorship would be an acquisition of a separate unit of the R Company's business.

Example (4). The S Corporation is engaged in the manufacture and sale of steel and steel products. S Corporation also owns a coal mine, which it operates for the sole purpose of supplying its coal requirements for its steel manufacturing operations. The acquisition of the coal mine would be an acquisition of a separate unit of the S company's business.

Example (5). The T Company, which is engaged in the business of operating a chain of drug stores, sells its only downtown drug store to the V Company and agrees not to open another T Company store in the downtown area for five years. Included in the purchase price is an amount that is charged for the goodwill of the store location. The V Company has acquired a separate unit of the T Company's business.

Example (6). The W Company, which is engaged in the business of operating a chain of drug stores sells one of its stores to the X Company, but continues to operate another drug store three blocks away. The X Company opens the store doing business under its own name. The X Company has not acquired a separate unit of the W Company's business.

Example (7). (a) The Y Corporation, which is engaged in the manufacture of mattresses, sells one of its three factories to the Z Company. At the time of the sale, the factory is capable of profitably manufacturing mattresses on its own. Z Company has acquired a separate unit of the Y Corporation.

(b) The facts are the same as in (a) above, except that a profitable manufacturing operation cannot be conducted in the factory standing on its own. Z Company has not acquired a separate unit of the Y Corporation.

Example (8). The O Construction Company is owned by A, B, and C, who are unrelated individuals. It owns equipment valued at 1.5 million dollars and construction contracts valued at 6 million dollars. A, wishing to start his own company, exchanges his interest in O Company for 2 million dollars of contracts and a sufficient amount of equipment to enable him to begin business immediately. A has acquired a separate unit of the O Company's business.

(3) *Major portion.* All the facts and circumstances surrounding the transaction shall be taken into account in determining what constitutes a major portion of a trade or business (or separate unit). Factors to be considered include:

(i) The fair market value of the assets in the portion relative to the fair market value of the other assets of the trade or business (or separate unit);

(ii) The proportion of goodwill attributable to the portion of the trade or business (or separate unit);

(iii) The proportion of the number of employees of the trade or business (or separate unit) attributable to the

portion in the periods immediately preceding the transaction; and

(iv) The proportion of the sales or gross receipts, net income, and budget of the trade or business (or separate unit) attributable to the portion.

[T.D. 7553, 43 FR 31323, July 21, 1978]

§ 1.52-3 Limitations with respect to certain persons.

(a) *Mutual savings institutions.* In the case of an organization to which section 593 applies (that is, a mutual savings bank, a cooperative bank, or a domestic building and loan association), the amount of the credit allowable under section 44B shall be 50 percent of the amount otherwise determined under section 51, or, in the case of an organization under common control, under section 52 (a) or (b).

(b) *Regulated investment companies and real estate investment trusts.* In the case of a regulated investment company or a real estate investment trust subject to taxation under subchapter M, chapter 1 of the Code, the amount of the credit allowable under section 44B shall be reduced to the company's or trust's ratable share of the credit. The ratable share shall be the ratio which the taxable income of the regulated investment company or real estate investment trust for the taxable year bears to its taxable income increased by the amount of the deduction for dividends paid taken into account under section 852 (b)(2)(D) in computing investment company taxable income or under section 857(b)(2)(B) in computing real estate investment trust taxable income, as the case may be. For purposes of computing the ratable share, the reduction of the deduction for wage or salary expenses under section 280C shall not be taken into account.

(c) *Cooperatives.* (1) In the case of a cooperative organization described in section 1381(a), the amount of the credit allowable under section 44B shall be reduced to the cooperative's ratable share of the credit. The ratable share shall be the ratio which the taxable income of the cooperative for the taxable year bears to its taxable income increased by the amount of the deductions allowed under section 1382 (b) and (c). For purposes of computing the ratable share, the reduction of the deduction for wage or salary expenses under section 280C shall not be taken into account.

[T.D.7553, 43 FR 31324, July 21, 1978]

§ 1.53-1 Separate rule for pass-through of jobs credit.

(a) *In general.* Under section 53(b), in the case of a credit earned under section 44B by a partnership, estate or trust, or subchapter S corporation, the amount of the credit that may be taken into account by a partner, beneficiary, or shareholder may not exceed a limitation separately computed with respect to the partner's, beneficiary's, or shareholder's interest in the entity. The separate computation is required not only for the taxable year with respect to which the credit is earned but also each taxable year to which an unused credit attributable to an interest in such an entity is carried back or over. This section prescribes rules, under the authority of section 44B(b), relating to computation of the separate limitation.

(b) *Application of credit earned.* A credit earned under section 44B by a partnership, estate or trust, or subchapter S corporation shall be applied by a partner, beneficiary, or shareholder, to the extent allowed under section 53(b), before applying any other credit earned under section 44B. For example, if an individual has a new jobs credit from a proprietorship of $2,000 and from a partnership (after applying section 53(b)) of $1,800, but the credit must be limited under section 53(a) to $3,000, the entire $1,800 credit from the partnership would be applied before any part of the $2,000 amount is applied.

(c) *Amount of separate limitation.* The amount of the separate limitation is equal to the partner's, beneficiary's, or shareholder's limitation under section 53(a) for the taxable year multiplied by a fraction. The numerator of the fraction is the portion of the taxpayer's taxable income for the year attributable to the taxpayer's interest in the entity. The denominator of the fraction is the taxpayer's total taxable income for the year reduced by the zero bracket amount, if any.

(d) *Portion of taxable income attributable to an interest in a partnership, estate or trust, or subchapter S corporation*—(1) *General rule.* The portion of a taxpayer's taxable income attributable to an interest in a partnership, estate or trust, or subchapter S corporation is the amount of income from that entity the taxpayer is required to include in gross income, reduced by—

(i) The amount of the deductions allowed to the taxpayer that are attributable to the taxpayer's interest in the entity; and

(ii) A proportionate share of the deductions allowed to the taxpayer not attributable to a specific activity (as defined in paragraph (e)).

If a deduction comprises both an item that is attributable to the taxpayer's interest in the entity and an item or items that are not attributable to the interest in the entity, and if the deduction is limited by a provision of the Code (such as section 170(b), relating to limitations on charitable contributions), the deduction must be prorated among the items taken into account in computing the deduction. For example, if an individual makes a charitable contribution of $5,000 and his distributive share of a partnership includes $2,000 in charitable contributions made by the partnership, and if the charitable contribution deduction is limited to $3,500 under section 170(b), then the portion of the deduction allowed to the taxpayer that is not attributable to a specific activity is $2,500 ($3,500 × ($5,000 ÷ $7,000)) and the portion of the deduction allowed to the taxpayer that is attributable to the interest in the partnership is $1,000 ($3,500 × ($2,000 ÷ $7,000)).

(2) *Deductions attributable to an interest in an entity.* Examples of deductions that are attributable to the taxpayer's interest in an entity include (but are not limited to) a deduction under section 1202 attributable to a net capital gain passed through the entity, and a deduction attributable to a deductible item (such as a charitable contribution) that has been passed through the entity.

(3) *Computation of the proportionate share of deductions not attributable to a specific activity.* The proportionate share of a deduction of the taxpayer not attributable to a specific activity is obtained by multiplying the amount of the deduction by a fraction. The numerator of the fraction is the income from the entity that the taxpayer is required to include in gross income, reduced by the amount of the deductions of the taxpayer that are attributable to the taxpayer's interest in the entity. The denominator is the taxpayer's gross income reduced by the amount of all the deductions attributable to specific activities.

(4) *Examples.* The method of determining the amount of taxable income attributable to an interest in a partnership, estate or trust, or subchapter S corporation is illustrated by the following examples:

Example (1). (a) A, a single individual, is a shareholder in S Corporation, a subchapter S corporation. A is required to include the following amounts from S corporation is his gross income:

Salary	$3,000
Undistributed taxable income:	
Ordinary income	8,000
Net capital gain	2,000
Total	10,000
Total	13,000

A has income from other activities:

Ordinary income	6,000
Net capital gain	4,000
Total	10,000

(b) In order to determine the taxable income attributable to A's interest in S Corporation, it is necessary to reduce the amount of income from S Corporation that A is required to include in gross income by the amount of A's deductions attributable to the interest in S Corporation and by a proportionate share of A's deductions not attributable to a specific activity. These computations are made in paragraph (c) of this example. However, before the computation reducing A's income by a proportionate share of the deductions not attributable to a specific activity can be made, the ratio described in subparagraph (3) of this paragraph (d) must be determined. The numerator of the ratio (the amount of income from S Corporation that A is required to include in gross income, reduced by the amount of the deductions attributable to A's interest in S Corporation) is obtained in paragraph (c) of this example in the process of computing A's taxable income attributable to the interest in S Corporation. The determination of the denominator (A's gross income

reduced by the amount of all deductions attributable to specific activities), however, require a separate computation, which follows:

Gross income:	
Income from S Corporation	$13,000
Income from other sources	10,000
Total	23,000
Less: Deductions attributable to specific activities:	
Section 1202 deduction (50 pct. of $6,000)	3,000
A's gross income reduced by the amount of the deductions attributable to specific activities (denominator of the ratio for determining the proportionate share of deductions not attributable to a specific activity)	20,000

(c) Computation of the amount of A's taxable income attributable to the interest in S Corporation:

Income from S Corporation that A is required to include in gross income:	
Ordinary income	$11,000
Net capital gain	2,000
Total	13,000
Less: Deductions of the taxpayer attributable to the interest in S Corporation:	
Section 1202 deduction (50 pct. of $2,000)	1,000
(Numerator of the ratio for determining the proportionate share of deductions not attributable to a specific activity)	12,000
Less: Proportionate share of the deductions of the taxpayer not attributable to a specific activity:	
Personal exemption deduction ($750 × $12,000/$20,000)	450
Zero bracket amount ($2,200 × $12,000/$20,000)	1,320
Total	1,770
Portion of A's taxable income attributable to interest in S Corporation	10,230

Example (2). (a) C, a married individual with two children, is a partner in the CD Company. C's distributive share of the CD Company consists of the following:

Ordinary income (other than guaranteed payment)	$38,420
Guaranteed payment	20,000
Net long-term capital gain	6,000
Net short-term capital loss	2,000
Dividends qualifying for exclusion	100
Charitable contributions	500

C also has items of income from other sources and deductions, as follows:

Ordinary income	$21,680
Short-term capital gain	2,000
Dividends qualifying for exclusion	400
Deductions:	
Deductible medical expenses	16,000
Charitable contributions	4,000
Alimony	18,000
Interest and taxes on home	8,000
Loss relating to another specific activity	4,000

(b) In order to determine C's taxable income attributable to the interest in the partnership, it is necessary to reduce the amount of income from the partnership that C is required to include in gross income by the amount of C's deductions attributable to the interest in the partnership and by a proportionate share of C's deductions not attributable to a specific activity. These computations are made in paragraph (c) of this example. However, before the computation reducing C's income by a proportionate share of the deductions not attributable to a specific activity can be made, the ratio described in paragraph (d)(3) of this section must be determined. The numerator of the ratio is determined in paragraph (c) of this example in the process of computing C's taxable income attributable to the interest in the partnership. The denominator, however, requires a separate computation, reducing C's gross income by the amount of all deductions attributable to specific activities. This computation is as follows:

Gross income: Income from the partnership:	
Ordinary income	$58,420
Net long-term capital gain	6,000
Dividends	100
Less: Proportionate share of dividend exclusion ($100 × $100/$500)	20
	80
	64,500
Income from other sources:	
Ordinary income	21,680
Net short/term capital gain	2,000
Dividends	400
Less: Proportionate share of dividend exclusion ($100 × $400/$500)	$80
	320
	24,000
	88,500
Less: Deductions attributable to specific activities:	
Net short-term capital loss passed through the partnership	2,000
Loss related to another specific activity	4,000
Section 1202 deduction attributable to the interest in the partnership	2,000
Charitable contribution deduction passed through the partnership	500
	8,500

C's gross income, reduced by the amount of the deductions attributable to specific activities (denominator of the ratio for determining the proportionate share of deductions not attributable to a specific activity)	80,000

(c) Computation of the amount of C's taxable income attributable to the interest in the partnership:

Distributive share of ordinary income (other than guaranteed payments)	$38,420
Guaranteed payment	20,000
Distributive share of dividends less share of exclusion	80
Distributive share of net long-term capital gain	6,000
	64,500
Section 1202 deduction (50 pct. of $4,000)	2,000
Charitable contribution passed through the partnership	500
Net short-term capital loss passed through the partnership	2,000
	4,500
(Numerator of the ratio for determining the proportionate share of deductions not attributable to a specific activity)	60,000
Section 1202 deduction ($1,000 × $60,000/$80,000)	750
Deductible medical expenses ($16,000 × $60,000/$80,000)	12,000
Charitable contributions ($4,000 × $60,000/$80,000)	3,000
Alimony ($18,000 × $60,000/$80,000)	13,500
Interest and taxes on home ($8,000 × $60,000/$80,000)	6,000
Personal exemption deduction ($3,000 × $60,000/$80,000)	2,250
Total	37,500
Portion of C's taxable income attributable to the interest in the partnership	22,500

C has a deduction under section 1202 of $3,000. Of that deduction, $2,000 is attributable directly to C's interest in the partnership (50 percent of the net capital gain that would result from offsetting the $6,000 net long-term capital gain and the $2,000 net short-term capital loss that are attributable to C's interest in the partnership). Since the remaining $1,000 deduction under section 1202 cannot be attributed directly to either C's income from the partnership or any other specific activity, it must be treated as a deduction not attributable to a specific activity.

(e) *Deductions not attributable to a specific activity*—(1) *Specific activity" defined.* A specific activity" means a course of continuous conduct involving a particular line of endeavor, whether or not the activity is carried on for profit. Examples of a specific activity are:

(i) A trade or business carried on by the taxpayer;

(ii) A trade or business carried on by an entity in which the taxpayer has an interest;

(iii) An activity with respect to which the taxpayer is entitled to a deduction under section 212;

(iv) The operation of a farm as a hobby.

(2) *Types of deductions not attributable to a specific activity.* Examples of deductions not attributable to a specific activity include charitable contributions made by the partner, beneficiary, or shareholder; medical expenses; alimony; interest on personal debts of the partner, beneficiary, or shareholder; and real estate taxes on the personal residence of the partner, beneficiary, or shareholder. For purposes of this section, in cases in which deductions are not itemized, the zero bracket amount is considered to be a deduction not attributable to a specific activity.

(f) *Carryback or carryover of credit subject to separate limitation.* A credit subject to the separate limitation under section 53(b) that is carried back or carried over to another taxable year is also subject to the separate limitation in the carryback or carryover year. The taxpayer to whom the credit has been passed through shall not be prevented from applying the unused portion in a carryback or carryover year merely because the entity that earned the credit changes its form of conducting business if the nature of its trade or business essentially remains the same. The computation of the separate limitation in such a case shall reflect the income attributable to the taxpayer's interest in the entity in its revised form. Thus, a shareholder carrying over a credit from a subchapter S corporation may include dividends declared by that corporation after the subchapter S election had been terminated as income attributable to that person's interest in the entity. Similarly, if a partnership incorporates in a carryover year, any income attributable to an interest in the corporation will be regarded, for purposes of computing the separate

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limitation under section 53(b), as income attributable to an interest in the entity.

[T.D. 7560, 43 FR 60445, Dec. 28, 1978]

§ 1.56–1 Imposition of tax.

(a) *In general.* Section 56(a) imposes an income tax on the items of tax preference (as defined in § 1.57–1) of all persons other than persons specifically exempt from the taxes imposed by chapter 1. The items of tax preference represent income of a person which either is not subject to current taxation by reason of temporary exclusion (such as stock options) or by reason of an acceleration of deductions (such as accelerated depreciation) or is sheltered from full taxation by reason of certain deductions (such as percentage depletion) or by reason of a special rate of tax (such as the rate of tax on corporate capital gains). The tax imposed by section 56 is in addition to the other taxes imposed by chapter 1.

(b) *Computation of tax.* The amount of such tax is 10 percent of the excess (referred to herein as "the minimum tax base") of—

(1) The sum of the taxpayer's items of tax preference for such year in excess of the taxpayer's minimum tax exemption (determined under § 1.58–1) for such year, over

(2) The sum of:

(i) The taxes imposed for such year under chapter 1 other than the taxes imposed by section 56 (relating to minimum tax for tax preferences), by section 531 (relating to accumulated earnings tax), or by section 541 (relating to personal holding company tax), reduced by the sum of the credits allowable under—

(*a*) Section 33 (relating to taxes of foreign countries and possessions of the United States),

(*b*) Section 37 (relating to retirement income),

(*c*) Section 38 (relating to investment credit),

(*d*) Section 40 (relating to expenses of work incentive programs), and

(*e*) Section 41 (relating to contributions to candidates for public office, and

(ii) The tax carryovers to such taxable year (as described in § 1.56–5).

(c) *Special rule.* For purposes of paragraph (b) of this section where for any taxable year in which a tax is imposed under section 667 (relating to treatment of amounts deemed distributed by a trust in preceding years), that portion of the section 667 tax representing an increase in an earlier year's chapter 1 taxes (as recomputed), which taxes are allowed as a reduction in any such earlier year's minimum tax base, is not allowable as a reduction in the minimum tax base for the current taxable year. The remaining portion of the section 667 tax, representing the taxes imposed by section 56, section 531, and section 541, is not allowable as a reduction in the minimum tax base for any taxable year. Similarly, taxes imposed under section 614(c)(4) (relating to increase in tax with respect to aggregation of certain mineral interests) or under section 1351(d) (relating to recoveries of foreign expropriation losses) for any taxable year are not allowed as a reduction in the minimum tax base for such taxable year to the extent they represent chapter 1 taxes which are allowed as a reduction in a minimum tax base for an earlier taxable year for purposes of the computations under section 614(c)(4) or section 1351(d) or to the extent they represent an increase in the tax imposed by section 56, section 531, or section 541 in an earlier taxable year.

[T.D. 7564, 43 FR 40466, Sept. 12, 1978]

§ 1.56–2 Deferral of tax liability in case of certain net operating losses.

(a) *In general.* Section 56(b) provides for the deferral of liability for the minimum tax where, for the taxable year, the taxpayer has—

(1) A net operating loss for such taxable year any portion of which (under sec. 172) remains as a net operating loss carryover to a succeeding taxable year, and

(2) Items of tax preference in excess of the minimum tax exemptions (hereinafter referred to as "excess tax preferences").

In such a case, an amount of tax equal to the lesser of the tax imposed under section 56(a) (after allowance of the retirement income credit to the extent

that such credit cannot be used against the other taxes imposed by chapter 1) or 10 percent of the amount of the net operating loss carryover described in subparagraph (1) of this paragraph is deferred. Such amount is not treated as tax imposed in such taxable year, but is treated as tax imposed in the succeeding taxable year or years in which the net operating loss is used as provided in paragraphs (b) and (c) of this section. Deferral will result in the above case regardless of the character of the tax preference items. Thus, for example, if the taxpayer has $1,030,000 of items of tax preference, including the stock option item of tax preference, and a $750,000 net operating loss available for carryover to subsequent taxable years, the amount of tax imposed for the taxable year under section 56(a) is $100,000 and $75,000 is deferred by application of section 56(b). Therefore, only $25,000 is treated as tax imposed for the taxable year. The provisions of this section are applicable in the case of a net operating loss or comparable item such as an operations loss under section 812 and an unused loss as defined in section 825(b).

(b) *Year of liability.* In any taxable year in which any portion of a net operating loss carryover attributable to the amount of excess tax preferences reduces taxable imcome (in the form of a net operating loss deduction), section 56(b)(2) treats as tax liability imposed in such taxable year an amount equal to 10 percent of such reduction. For this purpose, the portion of such net operating loss which is considered attributable to the amount of excess tax preferences is an amount equal to the lesser of such excess or the amount of the net operating loss carryover described in paragraph (a)(1) of this section. In no case, however, shall the total amount of tax imposed by reason of section 56(b) in subsequent years exceed the amount of the tax that was deferred in the loss year.

(c) *Priority of reduction.* (1) If a portion of a net operating loss is attributable to an amount of excess tax preferences, such portion is considered to reduce taxable income in succeeding taxable years only after the other portion (if any) of such net operating loss is used to reduce taxable income. Accordingly, if the amount of a net operating loss which may be carried to succeeding taxable years is reduced because of a modification required to be made pursuant to section 172(b)(2), such reduction is to be considered to be first from that portion of the net operating loss that is attributable to excess tax preferences. If a portion of a net operating loss carryover which is attributable to an amount of excess tax preferences is not used to reduce taxable income in any succeeding taxable year, no minimum tax will be imposed with respect to such portion.

(2) In the case of taxpayers with deductions attributable to foreign sources which are suspense preferences (as defined in paragraphs (c)(1)(ii) and (2)(ii) of sec. 1.58–7), the amount of such deductions is not included in the portion of the net operating loss not attributable to excess tax preferences. The portion of the net operating loss attributable to excess tax preferences is increased by the amount of suspense preferences which are, in accordance with the provisions of section 1.58–7(c), converted to actual items of tax preference (and not used against the minimum tax exemption of the loss year) in subsequent taxable years. The other portion of the net operating loss is increased by the amount of suspense preferences which reduce taxable income in subsequent taxable years but are not converted to actual items of tax preference (or are so converted but used against the minimum tax exemption of the loss year). See section 1.58–7(c)(1)(iii) example (4).

(d) *Multiple net operating loss carryovers.* In determining whether a net operating loss is used to reduce taxable income in a taxable year to which two or more net operating losses are carried, the ordering rules of section 172(b) and the regulations thereunder are to be applied. Thus, for example, the portion of a net operating loss carried over from an earlier taxable year which is attributable to an amount of excess tax preference is used to reduce taxable income in the carryover year before any portion of any other net operating loss carried over or back

from a taxable year subsequent to the earlier taxable year.

(e) *Examples.* The application of this section may be illustrated by the following examples:

Example (1). In 1970, A, a calendar year taxpayer, who is a single individual, has $180,000 of items of tax preference, a $150,000 net operating loss of which $100,000 may be carried forward, and no tax liability under chapter 1 without regard to the minimum tax. His minimum tax computed under section 56(a) is $15,000 (10 percent times ($180,000 minus $30,000)). Under section 56(b)(1) an amount equal to the lesser of the amount determined under section 56(a) ($15,000) or 10 percent of the net operating loss which may be carried forward ($10,000) is treated as a deferred liability. Thus, his minimum tax liability for 1970 is $5,000 ($15,000 minimum tax under section 56(a) minus $10,000 deferred tax liability under section 56(b)). If, in 1971, he has $80,000 of taxable income before the deduction for the 1970 net operating loss, his minimum tax liability is $8,000 (10 percent of the amount by which the net operating loss carryforward from 1970 reduces taxable income) plus any minimum tax liability resulting from items of tax preference arising in 1971. If, by reason of the modifications provided by section 172(b)(2), no portion of the 1970 net operating loss remains as a carryover from 1971, no further minimum tax liability will result from the items of tax preference arising in 1970.

Example (2). In 1970, A, a calendar year taxpayer who is a single individual, has $90,000 of items of tax preference, a $100,000 net operating loss available for carryover to future taxable years, no net operating loss carryovers from prior taxable years, and no tax liability under chapter 1 without regard to the minimum tax. His minimum tax computed under section 56(a) is $6,000 (10 percent times ($90,000 minus $30,000)). Under section 56(b)(1) an amount equal to the lesser of the amount determined under section 56(a) ($6,000) or 10 percent of the net operating loss subject to carryforward ($10,000) is treated as a deferred liability. Thus, A owes no minimum tax in 1970 and the entire $6,000 of minimum tax liability is deferred. Under section 56(b)(2), the portion of the net operating loss attributable to the excess tax preferences described in section 56(b)(1)(B) is $60,000.

(a) In 1971, A has $25,000 of taxable income before the deduction for the 1970 net operating loss. Thus, in 1971, A has no minimum tax liability attributable to the items of tax preference arising in 1970 since, by application of section 56(b)(3), the portion of the 1970 net operating loss carryforward not attributable to the excess described in section 56(b)(1)(B), or $40,000, is considered applied against taxable income before the remaining portion.

(b) In 1972, A has $50,000 of taxable income before the deduction for the remaining 1970 net operating loss. Thus, the first $15,000 of reduction in taxable income is considered as from the portion of the 1970 net operating loss carryforward not attributable to the excess tax preferences described in section 56(b)(1)(B) and the remaining $35,000 of reduction in taxable income is considered attributable to such excess. A's 1972 minimum tax attributable to items of tax preference arising in 1970 is, therefore, $3,500 (10 percent times $35,000).

(c) In 1973, A has $80,000 of taxable income before the deduction for the 1970 net operating loss. The remaining $25,000 of the 1970 net operating loss carryforward is used to reduce taxable income in 1973. Thus, A's 1973 minimum tax liability attributable to items of tax preference arising in 1970 is $2,500 (10 percent times $25,000).

Example (3). In 1971, M Corporation, a Western Hemisphere trade corporation (as defined in sec. 921), reporting on a calendar year basis has $20,000 of taxable income after all deductions including the Western Hemisphere trade deduction allowable under section 922 in the amount of $30,000. In 1970, M Corporation had a net operating loss of $100,000 all of which was available for carryover to 1971 and $60,000 of which was attributable to excess tax preferences. In computing the amount of the 1970 net operating loss carried over to 1972 pursuant to section 172(b), the 1971 Western Hemisphere trade corporation deduction is not taken into account. Thus, M Corporation's recomputed income under section 172(b) is $50,000 ($20,000 taxable income plus $30,000 Western Hemisphere trade corporation deduction). Pursuant to paragraph (c)(1) of this section, $20,000 of the $40,000 portion of the 1970 net operating loss not attributable to excess tax preferences is considered to reduce taxable income in 1971 and $30,000 of the $60,000 portion of the 1970 net operating loss attributable to excess tax preferences is considered reduced pursuant to section 172(b)(2). Thus, M Corporation has no 1971 minimum tax attributable to items of tax preference arising in 1970. Of the $50,000 remaining of the 1970 net operating loss, $30,000 is attributable to excess tax preference.

Example (4). In 1972, A, a calendar year taxpayer who is a single individual, has $25,000 of taxable income resulting from $50,000 of net long-term capital gains. In 1971, A had a net operating loss of $100,000 all of which is available to carryover to 1972 and $60,000 of which is attributable to excess tax preferences. By application of section 172(b) only $50,000 of the 1971 net

operating loss is carried over to 1973. Pursuant to paragraph (c) of this section, $25,000 of the $40,000 portion of the 1971 net operating loss not attributable to excess tax preferences is considered to reduce taxable income in 1972. Of the $50,000 remaining of the 1971 net operating loss, $15,000 is not attributable to excess tax preferences and $35,000 is attributable to excess tax preferences. Thus, the $25,000 section 1202 deduction, in effect, reduces the portion of the 1971 net operating loss attributable to excess tax preferences. Because a net operating loss carryover is reduced to the extent of any section 1202 deduction, section 1202 deductions do not normally produce a tax benefit in such circumstances and, pursuant to § 1.57-4, would not be treated as items of tax preference. However, in this case, to the extent the portion of the 1971 net operating loss carryover attributable to excess tax preferences is reduced by reason of the section 1202 deduction, such deduction does result in a tax benefit to the taxpayer and is, therefore, treated as an item of tax preference in 1971. See § 1.57-4(b)(2).

[T.D. 7564, 43 FR 40467, Sept. 12, 1978]

§ 1.56–3 Effective date.

(a) *In general.* The minimum tax is effective for taxable years ending after December 31, 1969.

(b) *Taxable year beginning in 1969 and ending in 1970.* In the case of a taxable year beginning in 1969 and ending in 1970, the amount of the minimum tax shall be an amount equal to the amount determined under section 56 multiplied by the following fraction:

Number of days in the taxable year ending after December 31, 1969 ÷ Number of days in the entire taxable year.

Where, by reason of section 56(b) and § 1.56–2, tax initially imposed in a 1969–70 fiscal year is deferred until a subsequent taxable year or years, the amount of such tax liability in any subsequent taxable year is determined by application of the above fraction. Section 21, relating to computation of tax in years where there is a change in rates, is not applicable to the initial imposition of the minimum tax for tax preferences. The applications of this paragraph may be illustrated by the following example:

Example. The taxpayer uses a June 30 fiscal year. For fiscal 1969–70 the taxpayer has $180,000 of items of tax preference and a $50,000 net operating loss. In fiscal year 1970–71, the taxpayer uses the full net operating loss carryover from 1969–70 to reduce his taxable income by $50,000. Thus, without regard to the proration rules applicable under this section, the taxpayer's minimum tax liability for items of tax preference arising in 1969–70 is $15,000, i.e., 10 percent × ($180,000 − $30,000), of which $5,000, i.e., 10 percent × $50,000, is deferred until 1970–71 under the principles of section 56(b) and section 1.56–2. By application of the above formula the taxpayer's actual minimum tax liability is $4,958.90 in 1969–70 and $2,479.45 in 1970–71 determined as follows:

1969–70: 181/365 × $10,000
1970–71: 181/365 × $5,000

[T.D. 7564, 43 FR 40468, Sept. 12, 1978]

§ 1.56–4 Certain taxpayers.

For application of the minimum tax in the case of estates and trusts, electing small business corporations, common trust funds, regulated investment companies, real estate investment trusts, and partnerships, see §§ 1.58–2 through 1.58–6.

[T.D. 7564, 43 FR 40468, Sept. 12, 1978]

§ 1.56–5 Tax carryovers.

(a) *In general.* Section 56(c) provides a 7-year carryover of the excess of the taxes described in paragraph (1) of such section imposed during the taxable year over the items of tax preference described in paragraph (2) of such section for such taxable year for the purpose of reducing the amount subject to tax under section 56(a) in subsequent taxable years.

(b) *Computation of amount of carryover.* The amount of tax carryover described in section 56(c) is the excess (if any) of—

(1) The taxes imposed for the taxable year under chapter 1 other than taxes imposed by section 56 (relating to minimum tax for tax preferences), by section 531 (relating to accumulated earnings tax), or by section 541 (relating to personal holding company tax), reduced by the sum of the credits allowable under—

(i) Section 33 (relating to taxes of foreign countries and possessions of the United States),

(ii) Section 37 (relating to retirement income,

(iii) Section 38 (relating to investment credit),

(iv) Section 40 (relating to expenses of work incentive programs), and

(v) Section 41 (relating to contributions to candidates for public office), over

(2) The sum of the taxpayer's items of tax preference for such year in excess of the taxpayer's minimum tax exemption (determined under § 1.58–1) for such year.

For purposes of section 56(c) and this section, taxes imposed in a taxable year ending on or before December 31, 1969, are not included in the taxes described in subparagraph (1) of this paragraph. In addition, the rules of paragraph (c) of § 1.56–1 are applicable in determining the taxable year for which taxes are imposed under chapter 1 for purposes of paragraph (a)(1) of this section.

(c) *Operation of carryover.* Tax carryovers attributable to the taxable year shall be carried over to each of the 7 succeeding taxable years as follows:

(1) To the first such succeeding taxable year to reduce in the manner described in paragraph (d) of this section the amount subject to tax under section 56(a) for such first succeeding taxable year and

(2) To the extent such amount is not used as a reduction in the amount subject to tax under section 56(a) for such taxable year, such amount (if any) is carried over to each of the succeeding 6 taxable years but only to the extent such amount is not used to reduce the amount subject to tax under section 56(a) in taxable years intervening between the taxable year to which such amount is attributable and the taxable year to which such amount may otherwise be carried over.

(d) *Priority of reduction.* Where tax carryovers attributable to two or more taxable years are carried over to a subsequent taxable year such amounts attributable to the earliest taxable year shall be used to reduce the amount subject to tax under section 56(a) for such subsequent taxable year before any such amounts attributable to a later taxable year.

(e) *Special rules*—(1) *Periods of less than 12 months.* A fractional part of a year which is a taxable year under section 441(b) or 7701(a)(23) is a taxable year for purposes of section 56(c) and this section.

(2) *Electing small business corporations.* A taxable year for which a corporation is an electing small business corporation (as defined in section 1371(b)) shall be counted as a taxable year for purposes of determining the taxable years to which amounts which are available as a carryover under paragraph (a) of this section may be carried whether or not such carryovers arose in a year in which an election was in effect.

(3) *Husband and wife*—(i) *From joint to separate return.* If a joint return is filed by a husband and wife in a taxable year or years to which a tax carryover is attributable but separate returns are filed in any subsequent taxable year to which such carryover may be carried over to reduce the amount subject to tax under section 56(a), such carryover described in paragraph (b) of this section shall be allocated between husband and wife for purposes of reducing the amount subject to tax under section 56(a) for such subsequent taxable year in accordance with the principles of § 1.172–7(d).

(ii) *From separate to joint return.* If separate returns are filed by a husband and wife in a taxable year or years in which a tax carryover is attributable but a joint return is filed in any subsequent taxable year to which such carryover may be carried over to reduce the amount subject to tax under section 56(a), such carryover shall be aggregated for purposes of reducing the amount subject to tax under section 56(a), for such subsequent taxable year.

(4) *Estates and trusts.* In the case of the termination of an estate or trust, tax carryovers attributable to the estate or trust shall not be allowed to the beneficiaries succeeding to the property of the estate or trust.

(5) *Corporate acquisitions.* In the case of a transaction to which section 381(a) applies, the acquiring corporation shall succeed to and take into account, as of the close of the date transfer the tax carryovers attributable to the distributor or distribution or transferor corporation. The portion of such carryovers which may be taken

into account under paragraph (b)(2)(ii) of § 1.56-1 for any taxable year shall not exceed the excess of (i) the sum of the items of tax preference for such year resulting from the continuation of the business in which the distributor or transferor corporation was engaged at the time of such transaction and the items of tax preference not related to the continuation of such business which are directly attributable to the assets acquired from the distributor or transferor corporation over (ii) an amount which bears the same ratio to the acquiring corporation's minimum tax exemption for such year as the items of tax preference described in subdivision (i) of this subparagraph bears to all of the acquiring corporation's items of tax preference for such year. This item shall be taken into account by the acquiring corporation subject to the rules in section 381(b) and the regulations thereunder.

(f) *Suspense preferences.* Where an item of tax preference which is a suspense preference (as defined in § 1.58-7) arises in a taxable year in which tax carryovers may be used to reduce the minimum tax base (or in which such carryovers arise the minimum tax liability for that year and the tax carryovers to subsequent taxable years shall be recomputed upon the conversion of the suspense preference in a subsequent year. In lieu of the above, in all cases, since there is no difference in tax consequence, the recomputation may be accomplished by recomputing the minimum tax liability of the taxable year in which the suspense preference arose without reduction of the minimum tax base for the tax carryovers which have been used as a reduction in the minimum tax base in intervening taxable years. If such method is used, the minimum tax liability of the intervening year is not recomputed and any tax carryovers carried from the taxable year in which the suspense preference arose which remain as a carryover in the year of conversion are reduced, in the priority provided in paragraph (d) of this section, to the extent used to reduce an increase in the minimum tax base for the earlier year resulting from the conversion of the suspense preference.

(g) *Taxes imposed in a taxable year beginning in 1969 and ending in 1970.* In the case of a taxable year beginning in 1969 and ending in 1970 the amount of the carryover determined under paragraph (b) of this section is reduced to an amount equal to the amount of such carryover (without regard to this paragraph) multiplied by the following fraction:

Number of days in taxable year ending after December 31, 1969 ÷ Number of days in the entire taxable year.

(h) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). A is a single individual who uses a June 30 fiscal year. For fiscal 1968-1969, A had income tax liability under chapter 1 in the amount of $100,000. For fiscal 1969-1970, A had items of tax preference in the amount of $212,500 and income tax liability under chapter 1 (other than taxes imposed under sections 56, 531, and 541) of $365,000.

(a) The chapter 1 tax attributable to fiscal 1968-1969 is not available as a carryover under section 56(c) to reduce the amount subject to tax under section 56(a) since this tax arose in a taxable year ending on or before December 31, 1969.

(b) A portion of the excess of chapter 1 tax over the amount subject to tax under section 56(a) attributable to fiscal year 1969-1970 is available as a carryover as provided in section 56(c) to reduce the amount subject to tax under section 56(a). The amount of this carryover is $91,000 computed as follows.

1. Carryover under paragraph (b) of this section:	
Chapter 1 taxes	$365,000
Items of tax preference in excess of exemption	182,500
Total	182,500
2. Reduction pursuant to paragraph (g) of this section:	

$$182/365 \times \$182,500 = \$91,000$$

Example (2). A is a calendar year taxpayer who is a single individual. In 1972, A had chapter 1 income tax liability (other than taxes imposed under sections 56, 531, and 541) of $200,000 and $50,000 of items of tax preference. In 1973, A had chapter 1 income tax liability (other than taxes imposed under sections 56, 531, and 541) of $120,000 and $40,000 of items of tax preference. In 1974, A had $400,000 of items of tax prefer-

ence and no liability for tax under chapter 1 other than under section 56(a). Under section 56(c), the excess of the taxes described in paragraph (1) of that section arising in an earlier taxable year not used to reduce the amount subject to tax under section 56(a) for such taxable year can be carried over as provided in section 56(c) to reduce the amount subject to tax under section 56(a).

(a) The amount of the carryover from 1972 is $180,000 computed as follows:

Carryover under paragraph (b) of this section:	
Chapter 1 taxes	$200,000
Items of tax preference in excess of exemption	20,000
Total	180,000

(b) The amount of the carryover from 1973 is $110,000 computed as follows:

Carryover under paragraph (b) of this section:	
Chapter 1 taxes	$120,000
Items of tax preference in excess of exemption	10,000
Total	110,000

(c) For 1974, the excess of taxes in the preceding taxable years is used to reduce the amount subject to tax under section 56(a). The amount of carryover attributable to excess taxes arising in 1972 is used before such excess arising in 1973. The amount of tax under section 56(a) is $8,000 computed as follows:

1974 tax preferences	$400,000
Less exemption	30,000
	370,000
Less 1972 carryover	180,000
	190,000
Less 1973 carryover	110,000
1974 minimum tax base	80,000
1974 minimum tax ($80,000 × 10%)	8,000

Example (3). The facts are the same as in example (2) except that in 1974 A had $300,000 of items of tax preference. The amount of the carryover for taxable years after 1974 is computed as follows:

1974 tax preferences	$300,000
Less exemption	30,000
	270,000
Less 1972 carryover	180,000
	90,000
Less 1973 carryover	90,000
Minimum tax base	0
1973 carryover	110,000
Amount used in 1974	90,000
Amount available for taxable years after 1974	20,000

The $20,000 remaining of the 1973 carryover is available to reduce the amount subject to tax under section 56(a) in 1975 or other future taxable years as provided in section 56(c).

Example (4). M Corporation is a calendar year taxpayer. N Corporation uses a June 30 fiscal year. For the fiscal year 1970-1971, N Corporation had excess chapter 1 tax liability as described in paragraph (a) of this section in the amount of $75,000. On January 1, 1972, M Corporation acquired N Corporation in a reorganization described in section 368(a)(1)(A). N Corporation does not use any of such excess chapter 1 tax liability to reduce the amount subject to tax under section 56(a) for the short taxable year beginning on July 1, 1971, and ending on December 31, 1971. Thus, the excess chapter 1 tax liability is available to M Corporation as a carryover under paragraph (a) of this section to reduce the amount subject to tax for the next 6 succeeding taxable years beginning with taxable year 1972 as provided in this section. In applying the carryover to 1972 and succeeding taxable years, the carryover of N Corporation subject to the limitation of § 1.56-5(e)(4) is combined with any carryovers originating with M Corporation in 1970.

[T.D. 7564, 43 FR 40468, Sept. 12, 1978]

§ 1.57-0 Scope.

For purposes of the minimum tax for tax preferences (subtitle A, ch. I, pt. VI), the items of tax preference are:

(a) Excess investment interest,

(b) The excess of accelerated depreciation on section 1250 property over straight line depreciation,

(c) The excess of accelerated depreciation on section 1245 property subject to a net lease over straight line depreciation,

(d) The excess of the amortization deduction for certified pollution control facilities over the depreciation otherwise allowable,

(e) The excess of the amortization deduction for railroad rolling stock over the depreciation otherwise allowable,

(f) The excess of the fair market value of a share of stock received pursuant to a qualified or restricted stock option over the exercise price,

(g) The excess of the addition to the reserve for losses on bad debts of financial institutions over the amount

which have been allowable based on actual experience,

(h) The excess of the percentage depletion deduction over the adjusted basis of the property, and

(i) The capital gains deduction allowable under section 1202 or an equivalent amount in the case of corporations.

Accelerated depreciation on section 1245 property subject to a net lease and excess investment interest are not items of tax preference in the case of a corporation, other than a personal holding company (as defined in section 542) and an electing small business corporation (as defined in section 1371(b)). In addition, excess investment interest is an item of tax preference only for taxable years beginning before January 1, 1972. Rules for the determination of the items of tax preference are contained in §§ 1.57-1 through 1.57-5. Generally, in the case of a nonresident alien or foreign corporation, the application of §§ 1.57-1 through 1.57-5 will be limited to cases in which the taxpayer has income effectively connected with the conduct of a trade or business within the United States. Special rules for the treatment of items of tax preference in the case of certain entities and the treatment of items of tax preference relating to income from sources outside the United States are provided in section 58 and in §§ 1.58-1 through 1.58-8.

[T.D. 7564, 43 FR 40470, Sept. 12, 1978]

§ 1.57-1 Items of tax preference defined.

(a) [Reserved]

(b) *Accelerated depreciation on section 1250 property*—(1) *In general.* Section 57(a)(2) provides that, with respect to each item of section 1250 property (as defined in section 1250(c)), there is to be included as an item of tax preference the amount by which the deduction allowable for the taxable year for depreciation or amortization exceeds the deduction which would have been allowable for the taxable year if the taxpayer had depreciated the property under the straight line method for each year of its useful life for which the taxpayer has held the property. The determination of the excess under section 57(a)(2) is made with respect to each separate item of section 1250 property. Accordingly, where the amount of depreciation which would have been allowable with respect to one item of section 1250 property if the taxpayer had originally used the straight line method exceeds the allowable depreciation or amortization with respect to such property, such excess may not be used to reduce the amount of the item of tax preference resulting from another item of section 1250 property.

(2) *Separate items of section 1250 property.* The determination of what constitutes a separate item of section 1250 property is to be made on the facts and circumstances of each individual case. In general, each building (or component thereof, if the taxpayer uses the component method of computing depreciation) is a separate item of section 1250 property. However, for purposes of this section, assets placed in a group, classified, or composite account are to be treated as a single item by a taxpayer, provided that such account contains only property placed in service during a single taxable year. In addition, two or more items may be treated as one item of section 1250 property for purposes of this paragraph where, with respect to each such item: (i) The period for which depreciation is taken begins on the same date, (ii) the same estimated useful life has continually been used for purposes of taking depreciation or amortization, and (iii) the same method (and rate) of depreciation or amortization has continually been used. For example, assume a taxpayer constructed a 40-unit rental townhouse development and began taking declining balance depreciation on all 40 units as of January 1, 1970, at a uniform rate and has consistently taken depreciation on all 40 units on this same basis. Although each townhouse is a separate item of section 1250 property, all 40 townhouses may be treated as one item of section 1250 property for purposes of the minimum tax since the conditions of subdivisions (i), (ii), and (iii) of this subparagraph are met. This would be true even if the 40 townhouses comprised two 20-unit developments located apart from each other. However, if

the taxpayer constructed an additional development or new section on the existing development for which he began taking depreciation on July 1, 1970, at a uniform rate for all the additional units, the additional units and the original units may not be treated as one item of section 1250 property since the condition of subdivision (i) of this subparagraph is not met. Where a portion of an item of section 1250 property has been depreciated or amortized under a method (or rate) which is different from the method (or rate) under which the other portion or portions of such item have been depreciated or amortized, such portion is considered a separate item of section 1250 property for purposes of this paragraph.

(3) *Allowable depreciation or amortization.* The phrase "deduction allowable for the taxable year for exhaustion, wear and tear, obsolescence, or amortization" and references in this paragraph to "allowable depreciation or amortization" include deductions allowable for the taxable year under sections 162, 167, 212, or 611 for the depreciation or amortization of section 1250 property. Such phrase does not include depreciation allowable in the year in which the section 1250 property is disposed of. For the determination of "allowable depreciation or amortization" for taxable years in which the taxpayer has taken no deduction, see § 1.1016-3(a)(2).

(4) *Straight line depreciation.* (i) For purposes of computing the depreciation which would have been allowable for the taxable year if the taxpayer had depreciated the property under the straight line method for each taxable year of its useful life, the taxpayer must use the same useful life and salvage value as was used for the first taxable year in which the taxpayer depreciated or amortized the property (subject to redeterminations made pursuant to § 1.167(a)-1 (b) and (c)). If, however, for any taxable year, no useful life was used under the method of depreciation or amortization used or an artificial period was used, such as, for example, by application of section 167(k), or salvage value was not taken into account in determining the annual allowances, such as, for example, under the declining balance method, then, for purposes of computing the depreciation which would have been allowable under the straight line method for the taxable year—

(*a*) There is to be used the useful life and salvage value which would have been proper if depreciation had actually been determined under the straight line method (without reference to an artificial life) throughout the period the property was held, and

(*b*) Such useful life and such salvage value is to be determined by taking into account for each taxable year the same facts and circumstances as would have been taken into account if the taxpayer had used such method throughout the period the property was held.

If an election under § 1.167(a)-11(f), § 1.167(a)-12(e), or § 1.167(a)-12(f) is applicable to the property, the salvage value of the property shall be determined in accordance with such election, and the asset depreciation period (or asset guideline period) applicable to the property pursuant to such election shall be considered to be the useful life of the property for the purposes of this section.

(ii) Where the taxpayer acquires property in a transaction to which section 381(a) applies or from another member of an affiliated group during a consolidated return year and an "accelerated" method of depreciation as described in section 167(b) (2), (3), or (4) or section 167(j)(1) (B) or (C) is permitted (see § 1.381(c)(6)-1 and § 1.1502-12(g)), the depreciation which would have been allowable under the straight line method is determined as if the property had been depreciated under the straight line method since depreciation was first taken on the property by the transferor of such property. In such cases, references in this paragraph to the period for which the property is held or useful life of the property are treated as including the period beginning with the commencement of the original use of the property.

(iii) For purposes of section 57(a)(2), the straight line method includes the method of depreciation described in

§ 1.167(b)-1 or any other method which provides for a uniform proration of the cost or other basis (less salvage value) of the property over the estimated useful life of the property to the taxpayer (in terms of years, hours of use, or other similar time units) or estimated number of units to be produced over the life of the property to the taxpayer. If a method other than the method described in § 1.167(b)-1 is used, the estimated useful life or estimated units of production shall be determined in a manner consistent with subdivision (i) of this subparagraph.

(iv) In the case of property constructed by or improvements made by a lessee, the useful life is to be determined in accordance with § 1.167(a)-4.

(5) *Application for partial period.* If an item is section 1250 property for less than the entire taxable year, the allowable depreciation or amortization includes only the depreciation or amortization for that portion of the taxable year during which the item is section 1250 property and the amount of the depreciation which would have been allowable under the straight line method is determined only with regard to such portion of the taxable year.

(6) *No section 1250 and basis adjustment.* No adjustment is to be made as a result of the minimum tax either to the basis of section 1250 property or with respect to computations under section 1250.

(7) *Example.* The principles of this paragraph may be illustrated by the following example:

Example. The taxpayer's only item of section 1250 property is an office building with respect to which operations were commenced on January 1, 1971. The taxpayer depreciates the component parts of the building on the declining balance method. The useful life and costs of the component parts for depreciation purposes are as follows:

Asset	Useful life	Cost	Salvage value
Building shell	50	$400,000	$50,000
Partitions and walls	10	40,000	
Ceilings	10	20,000	
Electrical system	25	40,000	2,500
Heating and air-conditioning system	25	60,000	2,500

For purposes of computing the item of tax preference under this paragraph for the taxpayer, the partitions, walls, and ceilings may be grouped together and the electrical, heating, and air-conditioning systems may be grouped together since the period for which depreciation is taken began with respect to the assets within these two groups on the same date and the assets within each group have continually had the same useful life and have continually been depreciated under the same method (and rate).

(a) The taxpayer's 1971 item of tax preference under this paragraph would be determined as follows:

(1) Item of 1250 property	(2) Declining balance depreciation	(3) Straight line depreciation	(4) Excess of (2) over (3)
1. Shell	$12,000	$7,000	$5,000
2. Partitions, walls, ceilings	9,000	6,000	3,000
3. Electrical, heating and air-conditioning systems	6,000	3,800	2,200
1971 preference			10,200

(b) Assuming the above facts are the same for 1974, the taxpayer's 1974 item of tax preference under this paragraph would be determined as follows:

(1) Item of 1250 property	(2) Declining balance depreciation	(3) Straight line depreciation	(4) Excess of (2) over (3)
1. Shell	$10,952	$7,000	$3,952
2. Partitions, walls, ceilings	5,529	6,000	None
3. Electrical, heating and air-conditioning systems	4,983	3,800	1,183
1974 preference			5,135

(c) *Accelerated depreciation on section 1245 property subject to a net lease*—(1) *In general.* Section 57(a)(3) provides that, with respect to each item of section 1245 property (as defined in section 1245(a)(3)) which is the subject of a net lease for the taxable year, there is to be included as an item of tax preference the amount by which the deduction allowable for the taxable year for depreciation or amortization exceeds the deduction which would have been allowable for the taxable year if the taxpayer had depreciated the property under the straight line method for each year of its useful life for which the taxpayer has held the property. Except as provided in paragraph (b)(1)(ii) of this section, the determination of the excess under section 57(a)(3) is made with respect to each separate item of section 1245 property. Accordingly, where the amount of depreciation which would have been allowable with respect to one item of section 1245 property if the taxpayer had originally used the straight line method exceeds the allowable depreciation or amortization with respect to such property, such excess may not be used to reduce the amount of the item of tax preference resulting from another item of section 1245 property.

(2) *Separate items of property.* The determination of what constitutes a separate item of section 1245 property must be made on the facts and circumstances of each individual case. Such determination shall be made in a manner consistent with the principles expressed in paragraph (b)(2) of this section.

(3) *Allowable depreciation or amortization.* The phrase "deduction allowable for the taxable year for exhaustion, wear and tear, obsolescence, or amortization" and references in this paragraph to "allowable depreciation or amortization" include deductions allowable for the taxable year under sections 162, 167 (including depreciation allowable under section 167 by reason of section 179), 169, 184, 185, 212, or 611 for the depreciation or amortization of section 1245 property. Such phrase does not include depreciation allowable in the year in which the section 1245 property is disposed of. Amortization of certified pollution control facilities under section 169, and amortization of railroad rolling stock under section 184 are not to be treated as amortization for purposes of section 57(a)(3) to the extent such amounts are treated as an item of tax preference under section 57(a) (4) or (5) (see paragraphs (d) and (e) of this section). For the determination of "allowable depreciation or amortization" for taxable years in which the taxpayer has taken no deduction, see § 1.1016-3(a)(2).

(4) *Straight line method of depreciation.* The determination of the depreciation which would have been allowable under the straight line method shall be made in a manner consistent with paragraph (b)(4) of this section. Such amount shall include any amount allowable under section 167 by reason of section 179 (relating to additional first-year depreciation for small business).

(5) *Application for partial period.* If an item is section 1245 property for less than the entire taxable year or subject to a net lease for less than the entire taxable year the allowable depreciation or amortization includes only the depreciation or amortization for that portion of the taxable year during which the item was both section 1245 property and subject to a net lease and the amount of the depreciation which would have been allowable under the straight line method is

to be determined only with regard to such portion of the taxable year.

(6) *Net lease.* Section 57(a)(3) applies only if the section 1245 property is the subject of a net lease for all or part of the taxable year. See § 1.57-3 for the determination of when an item is considered the subject of a net lease.

(7) *No section 1245 and basis adjustment.* No adjustment is to be made as a result of the minimum tax either to the basis of section 1245 property or with respect to computations under section 1245.

(8) *Nonapplicability to corporations.* Section 57(a)(3) does not apply to a corporation other than an electing small business corporation (as defined in section 1371(b)) and a personal holding company (as defined in section 542).

(d) *Amortization of certified pollution control facilities*—(1) *In general.* Section 57(a)(4) provides that, with respect to each certified pollution control facility for which an election is in effect under section 169, there is to be included as an item of tax preference the amount by which the deduction allowable for the taxable year under such section exceeds the depreciation deduction which would otherwise be allowable under section 167. The determination under section 57(a)(4) is made with respect to each separate certified pollution control facility. Accordingly, where the amount of the depreciation deduction which would otherwise be allowable under section 167 with respect to one facility exceeds the allowable amortization deduction under section 169 with respect to such facility, such excess may not be used to offset an item of tax preference resulting from another facility.

(2) *Separate facilities.* The determination of what constitutes a separate facility must be made on the facts and circumstances of each individual case. Generally, each facility with respect to which a separate election is in effect under section 169 shall be treated as a separate facility for purposes of this paragraph. However, if the depreciation or amortization which would have been allowable without regard to section 169 with respect to any part of a facility is based on a different useful life, date placed in service, or method of depreciation or amortization from the other part or parts of such facility, such part is considered a separate facility for purposes of this paragraph. For example, if a building constitutes a certified pollution control facility and various component parts of the building have different useful lives, each group of component parts with the same useful life would be treated as a separate facility for purposes of this paragraph. Two or more facilities may be treated as one facility for purposes of this paragraph where, with respect to each such facility: (i) the initial amortization under section 169 commences on the same date, (ii) The facility is placed in service on the same date, (iii) the estimated useful life which would be the basis for depreciation or amortization other than under section 169 has continually been the same, and (iv) the method of depreciation or amortization which could have been used without regard to section 169 could have continually been the same.

(3) *Amount allowable under section 169.* For purposes of the determination of the amount of the deduction allowable under section 169, see section 169 and the regulations thereunder. Such amount, however, does not include amortization allowable in the year in which the pollution control facility is disposed of.

(4) *Otherwise allowable deduction.* (i) The determination of the amount of the depreciation deduction otherwise allowable under section 167 is made as if the taxpayer had depreciated the property under section 167 for each year of its useful life for which the property has been held. This amount may be determined under § 1.167(a)-(11)(c) if the property is eligible property (as defined in § 1.167(a)-11(b)(2)) and, during the taxable year in which the property was first placed in service, the taxpayer—

(*a*) Has made an election under § 1.167(a)-11(f) with respect to eligible property first placed in service in such taxable year, or

(*b*) Has placed no eligible property in service other than property described in § 1.167(a)-11(b)(5) (iii), (iv), or (v).

The amount determined pursuant to the preceding sentence shall be determined as if the taxpayer had depreciated the property in accordance with § 1.167(a)-11 for all years to which such section applies and during which the taxpayer held the property. This amount may be determined under § 1.167(a)-12(a)(5) if the property is qualified property (as defined in § 1.167(a)-12 (a)(3)) and the taxpayer has made an election with respect to such property under § 1.167(a)-12(e). If the taxpayer has made an election under § 1.167(a)-12(f)(1) for a taxable year ending before January 1, 1971, this amount shall be determined for such year in accordance with such election. For purposes of this determination, any method selected by the taxpayer which would have been permissible under section 167 for such taxable year, including accelerated methods, may be used. Any additional amount which would have been allowable by reason of section 179 (relating to additional first-year depreciation for small business) may be included provided such amount is reflected in the determination made under this paragraph in subsequent years.

(ii) If a deduction for depreciation has not been taken by the taxpayer in any taxable year under section 167 with respect to the facility—

(*a*) There is to be used the useful life and salvage value which would have been proper under section 167.

(*b*) Such useful life and salvage value is determined by taking into account for each taxable year the same facts and circumstances as would have been taken into account if the taxpayer had used such method throughout the period the property has been held, and

(*c*) The date the property is placed in service is, for purposes of this section, deemed to be the first day of the first month for which the amortization deduction is taken with respect to the facility under section 169.

If, prior to the date amortization begins under section 169, a deduction for depreciation has been taken by the taxpayer in any taxable year under section 167 with respect to the facility, the useful life, salvage value, etc., used for that purpose is deemed to be the appropriate useful life, salvage value, etc., for purposes of this paragraph, with such adjustments as are appropriate in light of the facts and circumstances which would have been taken into account since the time the last such depreciation deduction was taken, unless it is established by clear and convincing evidence that some other useful life, salvage value, or date the property is placed in service is more appropriate.

(iii) For purposes of section 57(a)(4) and this paragraph, if the deduction for amortization or depreciation which would have been allowable had no election been made under section 169 would have been—

(*a*) An amortization deduction based on the term of a leasehold or

(*b*) A depreciation deduction determined by reference to section 611,

such deduction is to be deemed to be a deduction allowable under section 167.

(iv) If a facility is subject to amortization under section 169 for less than the entire taxable year, the otherwise allowable depreciation deduction under section 167 shall be determined only with regard to that portion of the taxable year during which the election under section 169 is in effect.

(v) If less than the entire adjusted basis of a facility is subject to amortization under section 169, the otherwise allowable depreciation deduction under section 167 shall be determined only with regard to that portion of the adjusted basis subject to amortization under section 169.

(5) *No section 1245 and basis adjustment.* No adjustment is to be made as a result of the minimum tax either to the basis of a certified pollution control facility or with respect to computations under sections 1245.

(6) *Relationship to section 57(a)(3).* See paragraph (c)(3) with respect to an adjustment in the amount treated as amortization under that provision where both paragraphs (3) and (4) of section 57(a) are applicable to the same item of property.

(7) *Example.* The principles of this paragraph may be illustrated by the following example:

Example. A calendar year taxpayer has a certified pollution control facility on which

an election is in effect under section 169 commencing with January 1, 1971. No part of the facility is section 1250 property. The original basis of the facility is $100,000 of which $75,000 constitutes amortizable basis. The useful life of the facility is 20 years. The taxpayer depreciates the $25,000 portion of the facility which is not amortizable basis under the double declining method and began taking depreciation on January 1, 1971.

(a) The taxpayer's 1971 item of tax preference under this paragraph would be determined as follows:

1. Amortization deduction	$15,000
2. Depreciation deduction on amortizable basis (double declining method)	7,500
1971 preference (excess of 1 over 2)	7,500

(b) If the taxpayer terminated his election under section 169 in 1972 effective as of July 1, 1972, the taxpayer's 1972 item of tax preference would be determined as follows:

1. Amortization deduction	$7,500
2. Depreciation deduction on amortizable basis: Full year ($75,000 (original basis) less $7,500 ("depreciation" to 1-1-72) equals adjusted basis of $67,500, multiplied by 0.10 (double declining rate))	6,750
Portion of full year's depreciation attributable to amortization period (one-half)	3,375
1972 preference (excess of 1 over 2)	4,125

(e) *Amortization of railroad rolling stock*—(1) *In general.* Section 57(a)(5) provides that, with respect to each unit of railroad rolling stock for which an election is in effect under section 184, there is to be included as an item of tax preference the amount by which the deduction allowable for the taxable year under such section exceeds the depreciation deduction which would otherwise be allowable under section 167. The determination under section 57(a)(5) is made with respect to each separate unit of rolling stock. Accordingly, where the amount of the depreciation deduction which would otherwise be allowable under section 167 with respect to one unit exceeds the allowable amortization deduction under section 184 with respect to such unit, such excess may not be used to offset an item of tax preference resulting from another unit.

(2) *Separate units of rolling stock.* The determination of what constitutes a separate unit of rolling stock must be made on the facts and circumstances of each individual case. Such determination shall be made in a manner consistent with the manner in which the comparable determination is made with respect to separate certified pollution control facilities under paragraph (d)(2) of this section.

(3) *Amount allowable under section 184.* For purposes of the determination of the amount of the deduction allowable under section 184, see section 184. Such amount, however, does not include amortization allowable in the year in which the rolling stock is disposed of.

(4) *Otherwise allowable deduction.* The determination of the amount of the depreciation deduction otherwise allowable under section 167 is to be made in a manner consistent with the manner in which the comparable deduction with respect to certified pollution control facilities is determined under paragraph (d)(4) of this section.

(5) *No section 1245 or basis adjustment.* No adjustment is to be made as a result of the minimum tax either to the basis of a unit of railroad rolling stock or with respect to computations under section 1245.

(6) *Relationship to section 57(a)(3).* See paragraph (c)(3) of this section with respect to an adjustment in the amount treated as amortization under that provision where both paragraphs (3) and (5) of section 57(a) are applicable to the same item.

(f) *Stock options*—(1) *In general.* Section 57(a)(6) provides that with respect to each transfer of a share of stock pursuant to the exercise of a qualified stock option or a restricted stock option, there shall be included by the transferee as an item of tax preference the amount by which the fair market value of the share at the time of exercise exceeds the option price. The stock option item of tax preference is subject to tax under section 56(a) in the taxable year of the transferee in which the transfer is made.

(2) *Definitions.* See generally § 1.421-7 (e), (f), and (g) for the definitions of "option price," "exercise," and "transfer," respectively; however, in the case of a transfer of a share of stock pursuant to the exercise of a qualified stock option or a restricted

stock option after the death of an employee by the estate of the decedent (or by a person who acquired the right to exercise such option by bequest or inheritance or by reason of the death of the decedent), the term "option price" shall, for purposes of this paragraph, include both the consideration paid by the estate (or such person) for such share of stock and so much of the basis of the option as is attributable to such share of stock. For the definition of a qualified stock option see section 422(b) and § 1.422-2. For the definition of a restricted stock option see section 424(b) and § 1.424-2. The definitions and special rules contained in section 425 and the regulations thereunder are applicable to this paragraph.

(3) *Fair market value.* In accordance with the principles of section 83(a)(1), the fair market value of a share of stock received pursuant to the exercise of a qualified or restricted stock option is to be determined without regard to restrictions (other than nonlapse restrictions within the meaning of § 1.83-3(h)). Notwithstanding any valuation date given in section 83(a)(1), for purposes of this section, fair market value is determined as of the date the option is exercised.

(4) *Foreign source options.* In the case of an option attributable to sources within any foreign country or possession, see section 58(g) and § 1.58-8.

(5) *Inapplicability in certain cases.* (i) Section 57(a)(6) is inapplicable if during the same taxable year in which stock is transferred pursuant to the exercise of an option, the transferee makes a disposition (within the meaning of section 425(c)) of such stock. In the case of a nonresident alien, section 57(a)(6) is inapplicable to the extent the stock option is attributable (in accordance with the principles of sections 861 through 863 and the regulations thereunder) to sources without the United States.

(ii) Section 57(a)(6) is inapplicable if section 421(a) does not apply to the transfer because of employment requirements of section 422(a)(2) or section 424(a)(2).

(6) *Proportionate applicability.* Where, by reason of section 422 (b)(7) and (c)(3) (relating to percentage ownership limitations), only a portion of a transfer qualifies for application of section 421, the fair market value and option price shall be determined only with regard to that portion of the transfer which so qualifies.

(7) *No basis adjustment.* No adjustment shall be made to the basis of the stock received pursuant to the exercise of a qualified or restricted stock option as a result of the minimum tax.

(g) *Reserves for losses on bad debts of financial institutions*—(1) *In general.* Section 57(a)(7) provides that, in the case of a financial institution to which sections 585 or 593 (both relating to reserves for losses on loans) applies, there shall be included as an item of tax preference the amount by which the deduction allowable for the taxable year for a reasonable addition to a reserve for bad debts exceeds the amount that would have been allowable had the institution maintained its bad debt reserve for all taxable years on the basis of the institution's actual experience.

(2) *Taxpayers covered.* Section 57(a)(7) applies only to an institution (or organization) to which section 585 or 593 applies. See sections 585(a) and 593(a) and the regulations thereunder for a description of those institutions.

(3) *Allowable deduction.* For purposes of this paragraph, the amount of the deduction allowable for the taxable year for a reasonable addition to a reserve for bad debts is the amount of the deduction allowed under section 166(c) by reference to sections 585 or 593.

(4) *Actual experience.* (i) For purposes of this paragraph, the determination of the amount which would have been allowable had the institution maintained its reserve for bad debts on the basis of actual experience is the amount determined under section 585(b)(3)(A) and the regulations thereunder. For this purpose, the beginning balance for the first taxable year ending in 1970 is the amount which bears the same ratio to loans outstanding at the beginning of the taxable year as (*a*) the total bad debts sustained during the 5 preceding taxable years, adjusted for recoveries of bad debts during such period, bears to

(*b*) the sum of the loans outstanding at the close of such 5 taxable years. The taxpayer may, however, select a more appropriate balance based on its actual experience during a shorter period subject to the approval of the district director upon examination of the return provided there are unusual circumstances which indicate that such period is more indicative of the taxpayer's actual loss experience. Any such selection and approval shall be made in a manner consistent with the selection and approval of a bad debt reserve method under § 1.166-1(b). In the case of an institution which has been in existence for less than 5 taxable years as of the beginning of the first taxable year ending in 1970, the above formula for determining the beginning balance is applied by substituting the number of taxable years for which the institution has been in existence as of the beginning of the taxable year for "5" each time it appears. If any taxable year utilized in the above formula for determining the beginning balance is a short taxable year the amount of the bad debts, adjusted for recoveries, for such taxable year is modified by dividing such amount by the number of days in the taxable year and multiplying the resulting amount by 365. The beginning balance for any subsequent taxable year is the amount of the beginning balance of the preceding taxable year, decreased by bad debt losses during such year, increased by recoveries of bad debts during such year and increased by the lower of the maximum amount determined under section 585(b)(3)(A) for such year or the amount of the deduction allowed for such year. The application of this subdivision (i) may be illustrated by the following example:

Example. The Y Bank, a calendar year taxpayer, uses the reserve method of acounting for bad debts. On December 31, 1969, Y determines the balance of its reserve for bad debts to be $70,000 under the percentage method. On the same date Y's 5-year moving average is $52,000. Y incurs net bad debt losses (bad debt losses less recoveries of bad debts) of $3,000 for each of the years 1970, 1971, and 1972, which it charges to its reserve for bad debts. Y's 6-year moving averages computed under section 585(b)(3)(A) at the close of 1970, 1971, and 1972 are $50,000, $49,000, and $51,000, respectively. Y's preference items are computed as follows based upon additional facts assumed:

	1970	1971	1972
1. Bad debt reserve—percentage method			
(a) Balance beginning of year (closing balance prior year)	$70,000	$70,000	$68,000
(b) Net bad debts charged to reserve	3,000	3,000	3,000
(c) Subtotal	67,000	67,000	65,000
(d) Deduction allowed	3,000	1,000	4,000
(e) Balance end of year	70,000	68,000	69,000
2. Bad debt reserve— actual experience			
(a) Beginning balance (for 1970, 5-year moving average for other years, closing balance prior year)	52,000	50,000	48,000
(b) Net bad debts charged to reserve	3,000	3,000	3,000
(c) Subtotal	49,000	47,000	45,000
(d) Maximum amount under section 585 (b)(3)(A) (6-year moving average minus (c))	1,000	2,000	6,000
(e) Deduction allowed (line 1(d))	3,000	1,000	4,000
(f) Lower of (d) or (e)	1,000	1,000	4,000
(g) Closing balance (line (c) + (f))	50,000	48,000	49,000
3. Preference item under section 57(a)(7)			
(a) Deduction allowed	3,000	1,000	4,000
(b) Maximum amount under section 585(b)(3)(A)	1,000	2,000	6,000
(c) Preference item (excess of (a) over (b))	2,000	0	0

(ii) In the case of a new institution whose first taxable year ends after 1969, its beginning balance for its reserve for bad debts, for purposes of this paragraph, is zero and its reasonable addition to the reserve for such taxable year is determined on the basis of the actual experience of similar institutions located in the area served by the taxpayer.

(h) *Depletion*—(1) *In general.* Section 57(a)(8) provides that with respect to each property (as defined in section 614), there is to be included as an item of tax preference the amount by which the deduction allowable for the taxable year under section 611 for depletion for the property exceeds the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction for that taxable year). The determination under section 57(a)(8) is made with respect to each separate property. Thus, for example, if one mineral property has an adjusted basis remaining at the end of the taxable year, such basis may not be used to reduce the amount of an item of tax preference resulting from another mineral property.

(2) *Allowable depletion.* For the determination of the amount of the deduction for depletion allowable for the taxable year see section 611 and the regulations thereunder.

(3) *Adjusted basis.* For the determination of the adjusted basis of the property at the end of the taxable year see section 1016 and the regulations thereunder.

(4) *No basis adjustment.* No adjustment is to be made to the basis of property subject to depletion as a result ot the minimum tax.

(i) *Capital gains*—(1) *Taxpayers other than corporations.* Section 57(a)(9)(A) provides that, in the case of a taxpayer other than a corporation, there is to be included as an item of tax preference one-half of the amount by which the taxpayer's net long-term capital gain for the taxable year exceeds the taxpayer's net short-term capital loss for the taxable year. For this purpose, for taxable years beginning after December 31, 1971, the taxpayer's net long-term capital gain does not include an amount equal to the deduction allowable under section 163 (relating to interest expense) by reason of subsection (d)(1)(C) of that section, and the excess described in the preceding sentence is reduced by an amount equal to the reduction of disallowed interest expense by reason of section 163(d)(2)(B). Furthermore, the net long-term capital gain of an estate or trust does not include capital gains described in section 642(c)(4). Included in the computation of the taxpayer's capital gains item of tax preference are amounts reportable by the taxpayer as distributive shares of gain or loss from partnerships, estates or trusts, electing small business corporations, common trust funds, etc. See section 58 and the regulations thereunder with respect to the above entities.

Example. For 1971, A, a calendar year individual taxpayer, recognized $50,000 from the sale of securities held for more than 6 months. In addition, A received a $15,000 dividend from X Fund, a regulated investment company, $12,000 of which was designated as a capital gain dividend by the company pursuant to section 852(b)(3)(C). The AB partnership recognized a gain of $20,000 from the sale of section 1231 property held by the partnership. The AB partnership agreement provides that A is entitled to 50 percent of the income and gains of the partnership. A had net short-term capital loss for the year of $10,000. A's 1971 capital gains item of tax preference is computed as follows:

Capital gain recognized from securities	$50,000
Capital gain dividend from regulated investment company	12,000
Distributive share of partnership capital gain	10,000
Total net long-term capital gain	72,000
Less: net short-term capital loss	(10,000)
Excess of net long-term capital gain over net short-term capital loss	62,000
One-half of above excess	31,000

(2) *Corporations.* (i) Section 57(a)(9)(B) provides that in the case of corporations there is to be included as an item of tax preference with respect to a corporation's net section 1201 gain an amount equal to the product obtained by multiplying the excess of the net long-term capital gain over the net short-term capital loss by a fraction. The numerator of this fraction is the sum of the normal tax rate and the surtax rate under section 11 minus the alternative tax rate under section 1201(a) for the taxable year, and the denominator of the fraction is the sum of the normal tax rate and the surtax rate under section 11 for the taxable year. Included in the above computation are amounts reportable by the taxpayer as distributive shares of gain or loss from partnerships, estates or

trusts, common trust funds, etc. In certain cases the amount of the net section 1201 gain which results in preferential treatment will be less than the amount determined by application of the statutory formula. Therefore, in lieu of the statutory formula, the capital gains item of tax preference for corporations may in all cases be determined by dividing—

(*a*) The amount of tax which would have been imposed under section 11 if section 1201(a) did not apply minus—

(*b*) The amount of the taxes actually imposed

by the sum of the normal tax rate plus the surtax rate under section 11. In case of foreign source capital gains and losses which are not taken into account pursuant to sections 58(g)(2)(B) and 1.58-8, the amount determined in the preceding sentence shall be multiplied by a fraction the numerator of which is the corporation's net section 1201 gain without regard to such gains and losses which are not taken into account and the denominator of which is the corporation's net section 1201 gain. The computation of the corporate capital gains item of tax preference may be illustrated by the following examples:

Example (1). For 1971, A, a calendar year corporate taxpayer, has ordinary income of $10,000 and net section 1201 gain of $50,000, none of which is subsection (d) gain (as defined in sec. 1201(d)) and none of which is attributable to foreign sources. A's 1971 capital gain item of tax preference may be computed as follows:

1. Tax under section 11:		
Normal tax (0.22 × $60,000)		$13,200
Surtax (0.26 × $35,000)		9,100
		22,300
2. Tax under section 1201:		
(a) Normal tax on ordinary income (0.22 × $10,000)		$2,200
Tax on net section 1201 gain (0.30 × $50,000)	$15,000	$17,200
3. Excess		5,100
4. Normal tax rate plus surtax rate		48
5. Capital gains preference (line 3 divided by line 4)		10,625

Example (2). For 1971, A, a calendar year corporate taxpayer, has a loss from operations of $30,000 and net section 1201 gain of $150,000, none of which is subsection (d) gain (as defined in sec. 1201(d)) and none of which is attributable to foreign sources. A's 1971 capital gain item of tax preference may be computed as follows:

1. Tax under section 11:		
Normal tax (0.22 × $120,000)		$26,400
Surtax (0.26 × $95,000)		24,700
		51,100
2. Tax under section 1201(a):		
Normal tax on ordinary income	None	
Tax on net section 1201 gain (0.30 × $150,000)	45,000	45,000
3. Excess		6,100
4. Normal tax rate plus surtax rate		.48
5. Capital gain preference (line 3 divided by line 4)		12,708

(ii) In the case of organizations subject to the tax imposed by section 511(a), mutual savings banks conducting a life insurance business (see sec. 594), life insurance companies (as defined in sec. 801), mutual insurance companies to which part II of subchapter L applies, insurance companies to which part III of subchapter L applies, regulated investment companies subject to tax under part I of subchapter M, real estate investment trusts subject to tax under part II of subchapter M, or any other corporation not subject to the taxes imposed by sections 11 and 1201(a), the capital gains item of tax preference may be computed in accordance with subdivision (i) of this subparagraph except that, in lieu of references to section 11, there is to be substituted the section which imposes the tax comparable to the tax imposed by section 11 and, in lieu of references to section 1201(a), there is to be substituted the section which imposes the alternative or special tax applicable to the capital gains of such corporation.

(iii) For purposes of this paragraph, where the net section 1201 gain is not in any event subject to the tax comparable to the normal tax and the surtax under section 11, such as in the case of regulated investment companies subject to tax under subchapter M, such comparable tax shall be computed as if it were applicable to net section 1201 gain to the extent such gain is subject to the tax comparable to the alternative tax under section 1201(a). Thus, in the case of a regulated investment company subject to tax under subchapter M, the tax comparable to the

normal tax and the surtax would be the tax computed under section 852(b)(1) determined as if the amount subject to tax under section 852(b)(3) were included in investment company taxable income. The principles of this subdivision (iii) may be illustrated by the following example:

Example. M, a calendar year regulated investment company, in 1971, has investment company taxable income (subject to tax under sec. 852(b)(1)) of $125,000 and net long-term capital gain of $800,000. M company has no net short-term capital loss but has a deduction for dividends paid (determined with reference to capital gains only) of $700,000. M's 1971 capital gains item of tax preference is computed as follows:

1 Section 852(b)(1) tax computed as if it were applicable to all income including capital gains:			
Amount subject to section 852(b)(1)		$125,000	
Net section 1201 gain	$800,000		
Less: Dividends paid deduction	700,000		
Net section 1201 gain subject to tax at the company level		100,000	
		225,000	
Normal tax (0.22 × $225,000)			$49,500
Surtax (0.26 × 200,000)			52,000
			101,500
2 Tax comparable to section 1201(a) tax section 852(b)(1) tax:			
Normal tax (0.22 × 125,000)	$27,500		
Surtax (0.26 × 100,000)	26,000	$53,500	
Section 852(b)(3) tax (0.30 × 100,000)		30,000	
			$83,500
3 Excess			18,000
4 Normal tax rate plus surtax rate			48
5 Capital gains preference (line 3 divided by line 4)			37,500

(iv) For the computation of the capital gains item of tax preference in the case of an electing small business corporation (as defined in sec. 1371(b)), see section 1.58-4(c).

(3) *Nonresident aliens, foreign corporations.* In the case of a nonresident alien individual or foreign corporation, there shall be included in computing the capital gains item of tax preference under section 57(a)(9) only those capital gains and losses included in the computation of income effectively connected with the conduct of a trade or business within the United States as provided in section 871(b) or 882

[T.D. 7564, 43 FR 40470, Sept. 12, 1978]

§ 1.57-2—§ 1.57-3 [Reserved]

§ 1.57-4 Limitation on amounts treated as items of tax preference for taxable years beginning before January 1, 1976.

(a) *In general.* If in any taxable year beginning before January 1, 1976, a taxpayer has deductions in excess of gross income and all or a part of any item of tax preference described in § 1.57-1 results in no tax benefit due to modifications required under section 172(c) or section 172(b)(2) in computing the amount of the net operating loss or the net operating loss to be carried to a succeeding taxable year, then, for purposes of section 56(a)(1), the sum of the items of tax preference determined under section 57(a) (and § 1.57-1) is to be limited as provided in paragraph (b) of this section.

(b) *Limitation.* The sum of the items of tax preference, for purposes of section 56(a)(1) and § 1.56-1(a), is limited to an amount determined under subparagraphs (1) and (2) of this paragraph.

(1) *Loss year.* If the taxpayer has no taxable income for the taxable year without regard to the net operating loss deduction, the amount of the limitation is equal to—

(i) In cases where the taxpayer does not have a net operating loss for the

taxable year, the amount of the recomputed income (as defined in paragraph (c) of this section) or

(ii) In cases where the taxpayer has a net operating loss for the taxable year, the amount of the net operating loss (expressed as a positive amount) increased by the recomputed income or decreased by the recomputed loss for the taxable year (as defined in paragraph (c) of this section,

plus the amount of the taxpayer's stock option item of tax preference (as described in § 1.57-1(f)).

(2) *Loss carryover and carryback years.* Except in cases to which subparagraph (1)(ii) of this paragraph applies, if, in any taxable year to which a net operating loss is carried, a capital gains deduction is disallowed under section 172(b)(2) in computing the amount of such net operating loss which may be carried to succeeding taxable years, the amount of the limitation is equal to the amount, if any, by which the sum of the items of tax preference (computed with regard to subparagraph (1)(i) of this paragraph) exceeds the lesser of—

(i) The amount by which such loss is reduced because of a disallowance of the capital gains deduction in such taxable year, or

(ii) The capital gains deduction.

The amount determined pursuant to the preceding sentence shall be increased by the amount, if any, that such reduction is attributable to that portion of such a net operating loss described in section 56(b)(1)(E) and § 1.56-2(a)(2) (relating to excess tax preferences).

(c) *Recomputed income or loss.* For purposes of this section, the phrase "recomputed income or loss" means the taxable income or net operating loss for the taxable year computed without regard to the amounts described in § 1.57-1 except paragraph (i)(2) of that section (relating to corporate capital gains) and without regard to the net operating loss deduction. For this purpose, the reference to the amounts described in § 1.57-1 is a reference to that portion of the deduction allowable in computing taxable income under the appropriate section equal to the amount which is determined in each paragraph of § 1.57-1. For example, the amount described in § 1.57-1(h) (relating to excess of percentage depletion over basis) is that portion of the deduction allowable for depletion under section 611 which is equal to the amount determined under § 1.57-1(h). For purposes of this paragraph, the amount described in § 1.57-1(i)(1) (relating to capital gains) is to be considered as the amount of the deduction allowable for the taxable year under section 1202.

(d) *Determination of preferences reduced.* When, pursuant to paragraph (b)(1) of this section, the sum of the items of tax preference (determined without regard to this section) are reduced, such reduction is first considered to be from the capital gains item of tax preference (described in § 1.57-1(i)(1)) and each item of tax preference relating to a deduction disallowed in computing the net operating loss pursuant to section 172(d), pro rata. The balance of the reduction, if any, is considered to be from the remaining items of tax preference, pro rata. For purposes of this subparagraph, deductions not attributable to the taxpayer's trade or business which do not relate to items of tax preference are considered as being applied in reducing gross income not derived from such trade or business before such deductions which do relate to items of tax preferences.

(e) *Examples.* The principles of this section may be illustrated by the following examples in each of which the deduction for the personal exemption is disregarded and the taxpayer is an individual who is a calendar year taxpayer.

Example (1). The taxpayer has the following items of income and deduction for 1970:

Gross income (all business income)	$120,000
Deductions:	
Nonbusiness deductions	30,000
Items of tax preference (excess accelerated depreciation on real property held in taxpayer's business)	80,000
Other business deductions	50,000

Based on the above figures, the taxpayer has a net operating loss of $10,000 (business deductions of $130,000 less business income of $120,000, the nonbusiness deductions

having been disallowed by reason of section 172(d)(4)). The limitation on the amount treated as items of tax preference is computed as follows:

Tax preferences			$80,000
Net operating loss		$10,000	
Recomputed income or loss:			
Gross income	$120,000		
Deductions other than tax preference items	80,000		
Recomputed income		40,000	
Sum of net operating loss and recomputed income		50,000	
Stock options preference		0	
Limitation			50,000

Thus, the minimum tax computed under section 56(a) would be 10 percent of $20,000 (items of tax preference of $50,000 less the minimum tax exemption of $30,000), $1,000 of which would be deferred tax liability pursuant to section 56(b).

Example (2). Assume the same facts as in example (1) except that the other business deductions are $130,000, resulting in a net operating loss of $90,000. The limitation on the amount treated as items of tax preference is computed as follows:

Tax preferences			$80,000
Net operating loss		$90,000	
Recomputed income or loss:			
Gross income	$120,000		
Deductions other than tax preference items	160,000		
	(40,000)		
Disallowance of nonbusiness deductions under sec. 172(d)	30,000		
Recomputed loss		10,000	
Net operating loss less recomputed loss		80,000	
Stock options preference		0	
Limitation			80,000

Thus, the minimum tax computed under section 56(a) would be 10 percent of $50,000 (items of tax preference of $80,000 less the minimum tax exemption of $30,000), of which would be deferred tax liability pursuant to section 56(b).

Example (3). The taxpayer has the following items of income and deduction for 1970:

Gross income (all from business):			
Ordinary			$50,000
Net section 1201 gains			120,000
Deductions:			
Items of tax preference:			
Excess amortization of certified poilution control facilities		$45,000	
Capital gains deduction		60,000	105,000
Other business deductions			75,000

In addition, the taxpayer has a $55,000 item of tax preference resulting from qualified stock options. Based on the above figures, the taxpayer has no taxable income and no net operating loss as the capital gains deduction is disallowed in determining the net operating loss pursuant to section 172(d). The limitation on the amount treated as items of tax preference is computed as follows:

Tax preferences			$160,000
Net operating loss		0	
Recomputed income or loss:			
Gross income	$170,000		
Deductions other than tax preference items	75,000		

Recomputed income		$95,000
Plus: Stock options preference		55,000
Limitation		150,000

Thus, the minimum tax computed under section 56 would be 10 percent of $120,000 (items of tax preference of $150,000 less the minimum tax exemption of $30,000).

Example (4). Assume the same facts as in example (3) except that the taxpayer has a net operating loss carryover from 1969 of $80,000. The taxpayer has $160,000 of tax preferences which are limited to $150,000 pursuant to § 1.57-4(b)(1). In order to determine the amount of the 1969 net operating loss which remains as a carryover to 1971, the 1970 taxable income is redetermined in accordance with section 172(b)(2) and the regulations thereunder, as follows:

Gross income—1970		$170,000
Deductions:		
Capital gains deduction disallowed business deductions	$120,000	120,000
Taxable income for section 172(b)(2)		50,000

Thus, the 1969 net operating loss which remains as a carryover to 1971 is $30,000. Pursuant to paragraph (b)(2) of this section, the limitation on the amount treated as items of tax preference is computed as follows:

Items of tax preference computed with regard to § 1.57-4(b)(1) (per example (3))	$150,000
Less: Lesser of capital gains deduction ($60,000) or amount of reduction in carryover due to its disallowance ($50,000)	50,000
Limitation	100,000

Thus, the minimum tax computed under section 56 would be 10 percent of $70,000 (items of tax preference of $100,000 less the minimum tax exemption of $30,000).

Example (5). The taxpayer has the following items of income and deduction for the taxable year 1970 without regard to any net operating loss deduction:

Gross income (all from business):		
Ordinary	$50,000	
Net section 1201 gain	40,000	
		$90,000
Deductions:		
Capital gains deduction	20,000	
Medical expenses ($4,100 actually paid but allowable only to the extent in excess of 3 percent of adjusted gross income of $70,000)	2,000	
Other itemized deductions	40,000	
		62,000
Taxable income (before net operating loss deduction)		28,000

In addition, the taxpayer has an item of tax preference of $35,000 resulting from qualified stock options. In 1973, the taxpayer has a net operating loss of $60,000 (no portion of which is attributable to excess tax preferences pursuant to § 1.56-2) which is carried back to 1970 resulting in no taxable income in 1970. In order to determine the amount of the 1973 net operating loss which remains as a carryover to 1971, the 1970 taxable income is redetermined, in accordance with section 172(b)(2) and the regulations thereunder, as follows:

Gross income		$90,000
Deductions:		
Capital gains deduction disallowed		
Medical expenses ($4,100 actually paid but allowable only to the extent in excess of 3 percent of adjusted gross income of $90,000)	$1,400	
Other itemized deductions	40,000	
		$41,400
Taxable income for section 172(b)(2)		48,600

The limitation on the amount treated as items of tax preference is computed as follows:

Items of tax preference:		
Capital gains		$20,000
Stock options		35,000
		55,000
Less:		
Lesser of capital gains deduction ($20,000) or amount of reduction in carryover due to its disallowance ($20,600)		(20,000)
Limitation		35,000

Thus, the minimum tax for 1970 under section 56 would be 10 percent of $5,000 (items of tax preference of $35,000 less the minimum tax exemption of $30,000).

Example (6). Assume the same facts as in example (5) except that the 1973 net operating loss was $45,000. In this case, the $20,600 increase in the 1970 taxable income as redetermined, results in a decrease of $17,000 (i.e., the remaining 1973 net operating loss after an initial decrease of $28,000 resulting from the 1970 taxable income before rede-

termination). The limitation on the amount treated as items of tax preference is computed as follows:

Items of tax preference computed without regard to this section	$55,000
Less: Lesser of capital gains deduction ($20,000) or amount of reduction in carryover due to its disallowance ($17,000)	(17,000)
Limitation	38,000

Thus, the minimum tax for 1970 under section 56 would be 10 percent of $8,000 (items of tax preference of $38,000 less the minimum tax exemption of $30,000).

Example (7). The taxpayer has the following items of income and deduction for 1973 without regard to any net operating loss deduction:

Gross income (all from business):		
Ordinary	$100,000	
Net section 1201 gains	120,000	
		$220,000
Deductions:		
Items of tax preference:		
Excess amortization of certified pollution control facilities	45,000	
Capital gains deduction	60,000	
	105,000	
Other business deductions	75,000	
		$180,000
Taxable income (before net operating loss deduction)		40,000

In 1972, the taxpayer had a net operating loss of $70,000 which is carried forward to 1973; $20,000 of this net operating loss is attributable to excess tax preferences. In order to determine the amount of the 1972 net operating loss which remains as a carryover to 1974, the 1973 taxable income is redetermined, in accordance with section 172(b)(2) and the regulations thereunder, as follows:

Gross income	$220,000
Deductions:	
Capital gains deduction	Disallowed
Business deductions	120,000
Taxable income per sec. 172(b)(2)	100,000

In this case, the $60,000 increase in the 1972 taxable income as redetermined and the $30,000 decrease in the amount of the 1973 net operating loss remaining as a carryover to 1974 (i.e., the remaining 1972 net operating loss after an initial decrease of $40,000 resulting from the 1973 taxable income before redetermination) is entirely attributable to the disallowance of the capital gains deduction. The limitation on the amount treated as items of tax preference is computed as follows:

Items of tax preference computed without regard to this section:	
Capital gains	$60,000
Excess amortization of certified pollution control facilities	45,000
	105,000
Less: Lesser of capital gains deduction (60,000) or amount of reduction in carryover due to its disallowance ($30,000)	(30,000)
	75,000
Plus: Amount of reduction of carryover (due to disallowance of capital gains deduction) attributable to excess tax preferences	20,000
Limitation	95,000

[T.D. 7564, 43 FR 40476, Sept. 12, 1978]

§ 1.57-5 Records to be kept.

(a) *In general.* The taxpayer shall have available permanent records of all the facts necessary to determine with reasonable accuracy the amounts described in § 1.57-1. Such records shall include:

(1) In the case of amounts described in paragraph (a) of § 1.57-1: the amount and nature of indebtedness outstanding for the taxable year and the date or dates on which each such indebtedness was incurred or renewed in any form; the amount expended for property held for investment during any taxable year during which such indebtedness was incurred or renewed; and the manner in which it was determined that property was or was not held for investment.

(2) In the case of amounts described in paragraphs (b), (c), (d), (e), and (h) of § 1.57-1:

(i) The dates, and manner in which, the property was acquired and placed in service,

(ii) The taxpayer's basis on the date the property was acquired and the manner in which the basis was determined,

(iii) An estimate of the useful life (in terms of months, hours of use, etc., whichever is appropriate) of the property on the date placed in service or an estimate of the number of units to be produced by the property on the date the property is placed in service, whichever is appropriate, and the manner in which such estimate was determined,

(iv) The amount and date of all adjustments by the taxpayer to the basis

of the property and an explanation of the nature of such adjustments, and

(v) In the case of property which has an adjusted basis reflecting adjustments taken by another taxpayer with respect to the property or taken by the taxpayer with respect to other property, the information described in subdivisions (i) through (iv) above, with respect to such other property or other taxpayer.

(3) In the case of amounts described in paragraph (f) of § 1.57-1, the fair market value of the shares of stock at the date of exercise of the option and the option price and the manner in which each was determined.

(4) In the case of amounts described in paragraph (g) of § 1.57-1, the amount of debts written off and the amount of the loans outstanding for the taxable year and the 5 preceding taxable years or such shorter or longer period as is appropriate.

(b) *Net operating losses.* The taxpayer shall have available permanent records for the first taxable year in which a portion of a net operating loss was attributable to items of tax preference (within the meaning of § 1.56-2 (b)) and each succeeding taxable year in which there is a net operating loss or a net operating loss carryover a portion of which is so attributable. Such records shall include all the facts necessary to determine with reasonable accuracy the amount of deferred tax liability under section 56, including the amount of the net operating loss in each taxable year in which there are items of tax preference in excess of the minimum tax exemption (as determined under § 1.58-1), the amount of the items of tax preference for each such taxable year, the amount by which each such net operating loss reduces taxable income in any taxable year, and the amount by which each such net operating loss is reduced in any taxable year.

[T.D. 7564, 43 FR 40479, Sept. 12, 1978]

§ 1.58-1 Minimum tax exemption.

(a) *In general.* For purposes of the minimum tax for tax preferences (subtitle A, chapter 1A, part VI), the minimum tax exemption is $30,000 except as otherwise provided in this section.

(b) *Husband and wife.* In the case of a married individual filing a separate return, section 58(a) provides that the minimum tax exemption is $15,000. This rule applies without regard to whether the married individual is living together with or apart from his spouse and without regard to whether or not his spouse has any items of tax preference.

(c) *Members of controlled groups*—(1) *Amount of exemption*—(i) *General rule.* Under section 58(b), if a corporation is a component member of a controlled group of corporations on December 31 (as defined in section 1563 (a) and (b) and the regulations thereunder), the minimum tax exemption for such taxable year which includes such December 31 is an amount equal to—

(*a*) $30,000 divided by the number of corporations which are component members of such group on December 31, or

(*b*) If an apportionment plan is adopted under subparagraph (3) of this paragraph, such portion of the $30,000 as is apportioned to such member in accordance with such plan.

(ii) *Consolidated returns.* The minimum tax exemption of a controlled group all of whose component members join in the filing of a consolidated return is $30,000. If there are component members of the controlled group which do not join in the filing of a consolidated return, and there is no apportionment plan effective under subparagraph (3) of this paragraph apportioning the $30,000 amoung the component members filing the consolidated return and the other component members of the controlled group, each component member of the controlled group (including each component member which joins in filing the consolidated return) is treated as a separate corporation for purposes of equally apportioning the $30,000 amount under subdivision (i)(*a*) of this subparagraph. In such case, the minimum tax exemption of the corporations filing the consolidated return is the sum of the amounts apportioned to each component member which joins in the filing of the consolidated return.

(2) *Certain short taxable years.* If the return of a corporation is for a short period which does not include a December 31, and such corporation is a component member of a controlled group of corporations with respect to such short period, the minimum tax exemption of such corporation for such short period is an amount equal to $30,000 divided by the number of corporations which are component members of such group on the last day of such short period. The minimum tax exemption so determined is also subject to the rules of section 443(d) (relating to reduction in the amount of the exemption for short periods) and the regulations thereunder. For purposes of this subparagraph, the term "short period" does not include any period if the income for such period is required to be included in a consolidated return under § 1.1502-76(b). The determination of whether a corporation is a component member of a controlled group of corporations on the last day of a short period is made by applying the definition of "component member" contained in section 1563(b) and § 1.1563-1 as if the last day of such short period were a December 31.

(3) *Apportionment of minimum tax exemption*—(i) *Apportionment plan.* (*a*) (In general.) In the case of corporations which are component members of a controlled group of corporations on a December 31, a single minimum tax exemption may be apportioned among such members if all such members consent, in the manner provided in subdivision (ii) of this subparagraph, to an apportionment plan with respect to such December 31. Such plan must provide for the apportionment of a fixed dollar amount to one or more of such members, but in no event may the sum of the amount so apportioned exceed $30,000. An apportionment plan is not considered as adopted with respect to a particular December 31 until each component member which is required to consent to the plan under subdivision (ii)(*a*) of this subparagraph files the original of a statement described in such subdivision (or, the original of a statement incorporating its consent is filed on its behalf). In the case of a return filed before a plan is adopted, the minimum tax exemption for purposes of such return is to be equally apportioned in accordance with subparagraph (1) of this paragraph. If a valid apportionment plan is adopted after the return is filed and within the time prescribed in (*b*) of this subdivision (i), such return must be amended (or a claim for refund should be made) to reflect the change from equal apportionment.

(*b*) (Time for adopting plan.) A controlled group may adopt an apportionment plan with respect to a particular December 31 only if, at the time such plan is sought to be adopted, there is at least 1 year remaining in the statutory period (including any extensions thereof) for the assessment of the deficiency against any corporation the tax liability of which would be increased by the adoption of such plan. If there is less than 1 year remaining with respect to any such corporation, the district director or the director of the service center with whom such corporation files its income tax return will ordinarily, upon request, enter into an agreement to extend such statutory period for the limited purpose of assessing any deficiency against such corporation attributable to the adoption of such apportionment plan.

(*c*) (Years for which effective.) (*1*) The amount apportioned to a component member of a controlled group of corporations in an apportionment plan adopted with respect to a particular December 31 constitutes such member's minimum tax exemption for its taxable year including the particular December 31, and for all taxable years including succeeding December 31's, unless the apportionment plan is amended in accordance with subdivision (iii) of this subparagraph or is terminated under (*c*)(*2*) of this subdivision (i). Thus, the apportionment plan (including any amendments thereof) has a continuing effect and need not be renewed annually.

(*2*) If an apportionment plan is adopted with respect to a particular December 31, such plan terminates with respect to a succeeding December 31, if: the controlled group goes out of existence with respect to such succeeding December 31 within the meaning of paragraph (b) of § 1.1562-5, any cor-

poration which was a component member of such group on the particular December 31 is not a component member of such group on such succeeding December 31, or any corporation which was not a component member of such group on the particular December 31 is a component member of such group on such succeeding December 31. An apportionment plan, once terminated with respect to a December 31, is no longer effective. Accordingly, unless a new apportionment plan is adopted, the minimum tax exemption of the component members of the controlled group for their taxable years which include such December 31 and all December 31's thereafter will be determined under subparagraph (1) of this paragraph.

(*3*) If an apportionment plan is terminated with respect to a particular December 31 by reason of the addition or withdrawal of a component member, each corporation which is a component member of the controlled group on such particular December 31 must, on or before the date it files its income tax return for the taxable year which includes such particular December 31, notify the district director or the director of the service center with whom it files such return to such termination. If an apportionment plan is terminated with respect to a particular December 31 by reason of the controlled group going out of existence, each corporation which was a component member of the controlled group on the preceding December 31 must, on or before the date it files its income tax return for the taxable year which includes such particular December 31, notify the district director or the director of the service center with whom it files such return to such termination.

(ii) *Consents to plan—(a) General rule.* (*1*) The consent of a component member (other than a wholly-owned subsidiary) to an apportionment plan with respect to a particular December 31 is to be made by means of a statement, signed by any person who is duly authorized to act on behalf of the consenting member, stating that such member consents to the apportionment plan with respect to such December 31. The statement must set forth the name, address, taxpayer identification number, and taxable year of the consenting component member, the amount apportioned to such member under the plan, and the internal revenue district or service center where the original of the statement is to be filed. The consent of more than one component member may be incorporated in a single statment. The original of a statement of consent is to be filed with he district director or the director of the service center with whom the component member of the group on such December 31 which has the taxable year ending first on or after such date filed its return for such taxable year. If two or more component members have the same such taxable year, a statement of consent may be filed with the district director or the director of the service center with whom the return for any such taxable year is filed. The original of a statement of consent is to have attached thereto information (referred to in this subdivision as "group identification") setting forth the name, address, taxpayer identification number, and taxable year of each component member of the controlled group on such December 31 (including wholly-owned subsidiaries) and the amount apportioned to each such member under the plan. If more than one original statement is filed, a statement may incorporate the group identification by reference to the name, address, taxpayer identification number, and taxable year of the component member of the group which has attached such group identification to the original of its statement.

(*2*) Each component member of the group on such December 31 (other than wholly-owned subsidiaries) must attach a copy of its consent (or a copy of the statement incorporating its consent) to the income tax return, amended return, or claim for refund filed with its district director or director of the service center for the taxable year including such date. Such copy must either have attached thereto information on group identification or must incorporate such information by reference to the name, address, taxpayer identification number, and taxable

year of the component member of the group which has attached such information to its income tax return, amended return, or claim for refund filed with the same district director or director of the service center for the taxable year including such date.

(b) *Wholly-owned subsidiaries.* (1) Each component member of a controlled group which is a wholly-owned subsidiary of such group with respect to a December 31 is deemed to consent to an apportionment plan with respect to such December 31, provided each component member of the group which is not a wholly-owned subsidiary consents to the plan. For purposes of this paragraph, a component member of a controlled group is considered to be a wholly-owned subsidiary of the group with respect to a December 31, if, on each day preceding such date and during its taxable year which includes such date, all of its stock is owned directly by one or more corporations which are component members of the group on such December 31.

(2) Each wholly-owned subsidiary of a controlled group with respect to a December 31 must attach a statement containing the information which is required to be set forth in a statement of consent to an apportionment plan with respect to such December 31 to the income tax return, amended return, or claim for refund filed with its district director or director of the service center for the taxable year which includes such date. Such statement must either have attached thereto information on group identification or incorporate such information by reference to the name, address, taxpayer identification number, and taxable year of a component member of the group which has attached such information to its income tax return, amended return, or claim for refund filed with the same district director or director of the service center for the taxable year including such date.

(iii) *Amendment of plan.* An apportionment plan adopted with respect to a December 31 by a controlled group of corporations may be amended with respect to such December 31 or with respect to any succeeding December 31 for which the plan is effective under subdivision (i)(c) of this subparagraph. An apportionment plan must be amended with respect to a particular December 31 and the amendments to the plan are effective only if adopted in accordance with the rules prescribed in this paragraph for the adoption of an original plan with respect to such December 31.

(iv) *Component members filing consolidated return.* If the component members of a controlled group of corporations on a December 31 include corporations which join the filing of a consolidated return, the corporations filing the consolidated return are treated as a single component member for purposes of this subparagraph. Thus, for example, only one consent executed by the common parent to an apportionment plan filed pursuant to this section is required on behalf of the component members filing the consolidated return.

(d) *Estates and trusts.* Section 58(c)(2) provides that, in the case of an estate or trust, the minimum tax exemption applicable to such estate or trust is an amount which bears the same ratio to $30,000 as the portion of the sum of the items of tax preference apportioned to the estate or trust bears to the full sum before apportionment. For example, if one-third of the sum of the items of tax preference of a trust are subject to tax at the trust level after apportionment under section 58(c)(1) and § 1.58-3, the trust's minimum tax exemption is $10,000. See § 1.58-3 for rules with respect to the apportionment of items of tax preference of an estate or trust.

(e) *Short taxable year.* See section 443(d) and § 1.443-1(d) with respect to reduction in the amount of the minimum tax exemption in the case of a short taxable year.

[T.D. 7564, 43 FR 40479, Sept. 12, 1978]

§ 1.58-2 General rules for conduit entities; partnerships and partners.

(a) *General rules for conduit entities.* Sections 1.58-3 through 1.58-6 provide rules under which items of tax preference of an estate, trust, electing small business corporation, common trust fund, regulated investment company, or real estate investment trust

(referred to in this paragraph as the "conduit entity") are treated as items of tax preference of the beneficiaries, shareholders, participants, etc. (referred to in this paragraph as the "distributees"). Where an item of tax preference of a conduit entity is so apportioned to a distributee, the item of tax preference retains its character in the hands of the distributee and is adjusted to reflect: (1) The separate items of income and deduction of the distributee and (2) the tax status of the distributee as an individual, corporation, etc. For example, if a trust has $100,000 of capital gains for the taxable year, all of which are distributed to A, an individual, the item of tax preference apportioned to A under section 57(a)(9) (and § 1.57-1(i)(1)) is $50,000. If, however, A had a net capital loss for the taxable year of $60,000 without regard to the distribution from the trust, the trust tax preference would be adjusted in the hands of A to reflect the separate items of income and deduction passed through to the distributee, or, in this case, to reflect the net section 1201 gain to A of $40,000. Thus, A's capital gains items of tax preference would be $20,000. By application of this rule, A, in effect, treats capital gains distributed to him from the trust the same as his other capital gains in computing his capital gains item of tax preference. If A had been a corporation, the trust tax preference would be adjusted both to reflect the capital loss and to reflect A's tax status by recomputing the capital gains item of tax preference (after adjustment for the capital loss) under section 57(a)(9)(B) and § 1.57-1(i)(2). Similarly, if depreciation on section 1245 property subject to a net lease (as defined in section 57(a)(3) and § 1.57-1(c)) is apportioned from a conduit entity to a corporation (other than a personal holding company or electing small business corporation), the amount so apportioned to the corporation is not treated as an item of tax preference to such corporation since such item is not an item of tax preference in the case of a corporation (other than a personal holding company or an electing small business corporation).

(b) *Partnerships and partners.* (1) Section 701 provides that a partnership as such is not subject to the income tax imposed by chapter 1. Thus, a partnership as such is not subject to the minimum tax for tax preferences. Section 702 provides that, in determining his income tax, each partner is to take into account separately his distributive share of certain items of income, deductions, etc. of the partnership and other items of income, gain, loss, deduction, or credit of the partnership to the extent provided by regulations prescribed by the Secretary or his delegate. Accordingly, each partner, in computing his items of tax preference, must take into account separately those items of income and deduction of the partnership which enter into the computation of the items of tax preference in accordance with subparagraph (2) of this paragraph.

(2) Pursuant to section 702, each partner must, solely for purposes of the minimum tax for tax preferences (to the extent not otherwise required to be taken into account separately under section 702 and the regulations thereunder), take into account separately in the manner provided in subchapter K and the regulations thereunder those items of income and deduction of the partnership which enter into the computation of the items of tax preference specified in section 57 and the regulations thereunder. A partner must, for this purpose, take into account separately his distributive share of:

(i) Investment interest expense (as defined in section 57(b)(2)(D) determined at the partnership level;

(ii) Investment income (as defined in section 57(b)(2)(B) determined at the partnership level;

(iii) Investment expenses (as defined in section 57(b)(2)(C)) determined at the partnership level;

(iv) With respect to each section 1250 property (as defined in section 1250(c)), the amount of the deduction allowable for the taxable year for exhaustion, wear and tear, obsolescence, or amortization and the deduction which would have been allowable for the taxable year had the property been depreciated under the straight

line method each taxable year of its useful life (determined without regard to section 167(k)) for which the partnership has held the property;

(v) With respect to each item of section 1245 property (as defined in section 1245(a)(3)) which is subject to a net lease, the amount of the deduction allowable for exhaustion, wear and tear, obsolescence, or amortization and the deduction which would have been allowable for the taxable year had the property been depreciated under the straight line method for each taxable year of its useful life for which the partnership has held the property;

(vi) With respect to each certified pollution control facility for which an election is in effect under section 169, the amount of the deduction allowable for the taxable year under such section and the deduction which would have been allowable under section 167 had no election been in effect under section 169;

(vii) With respect to each unit of railroad rolling stock for which an election is in effect under section 184, the amount of the deduction allowable for the taxable year under such section and the deduction which would have been allowable under section 167 had no election been in effect under section 184;

(viii) In the case of a partnership which is a financial institution to which section 585 or 593 applies, the amount of the deduction allowable for the taxable year for a reasonable addition to a reserve for bad debts and the amount of the deduction that would have been allowable for the taxable year had the institution maintained its bad debt reserve for all taxable years on the basis of actual experience; and

(ix) With respect to each mineral property, the deduction for depletion allowable under section 611 for the taxable year and the adjusted basis of the property at the end of the taxable year (determined without regard to the depreciation deduction for the taxable year).

If, pursuant to section 743 (relating to optional adjustment to basis), the basis of partnership property is adjusted with respect to a transferee partner due to an election being in effect under section 754 (relating to manner of electing optional adjustment), items representing amortization, depreciation, depletion, gain or loss, and the adjusted basis of property subject to depletion, described above, shall be adjusted to reflect the basis adjustment under section 743.

(3) The minimum tax is effective for taxable years ending after December 31, 1969. Thus, subparagraph (2) of this paragraph is inapplicable in the case of items of income or deduction paid or accrued in a partnership's taxable year ending on or before December 31, 1969.

[T.D. 7564, 43 FR 40481, Sept. 12, 1978]

§ 1.58-3 Estates and trusts.

(a) *In general.* (1) Section 58(c)(1) provides that the sum of the items of tax preference of an estate or trust shall be apportioned between the estate or trust and the beneficiary on the basis of the income of the estate or trust allocable to each. Income for this purpose is the income received or accrued by the trust or estate which is not subject to current taxation either in the hands of the trust or estate or the beneficiary by reason of an item of tax preference. The character of the amounts distributed is determined under section 652(b) or 662(b) and the regulations thereunder.

(2) Additional computations required by reason of excess distributions are to be made in accordance with the principles of sections 665-669 and the regulations thereunder.

(3) In the case of a charitable remainder annuity trust (as defined in section 664(d)(1) and § 1.664-2) or a charitable remainder unitrust (as defined in section 664(d)(2) and § 1.664-3), the determination of the income not subject to current taxation by reason of an item of tax preference is to be made as if such trust were generally subject to taxation. Where income of such a trust is not subject to current taxation in accordance with this section and is distributed to a beneficiary in a taxable year subsequent to the taxable year in which the trust received or accrued such income, the items of tax preference relating to such income are apportioned to the beneficiary in such subsequent year

(without credit for minimum tax paid by the trust with respect to items of tax preference which are subject to the minimum tax by reason of section 664(c)).

(4) Items of tax preference apportioned to a beneficiary pursuant to this section are to be taken into account by the beneficiary in his taxable year within or with which ends the taxable year of the estate or trust during which it has such items of tax preference.

(5) Where a trust or estate has items of income or deduction which enter into the computation of the excess investment interest item of tax preference, but such items do not result in an item of tax preference at the trust or estate level, each beneficiary must take into account, in computing his excess investment interest, the portion of such items distributed to him. The determination of the portion of such items distributed to each beneficiary is made in accordance with the character rules of section 652(b) or section 662(b) and the regulations thereunder.

(6) Where, pursuant to subpart E of part 1 of subchapter J (sections 671-678), the grantor of a trust or another person is treated as the owner of any portion of the trust, there shall be included in computing the items of tax preference of such person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent such items are taken into account under section 671 and the regulations thereunder. Any remaining portion of the trust is subject to the provisions of this section.

(b) *Examples.* The principles of this section may be illustrated by the following examples in each of which it is assumed that none of the distributions are accumulation distributions (see sections 665-669 and the regulations thereunder):

Example (1). Trust A, with one income beneficiary, has the following items of income and deduction without regard to the deduction for distributions:

Income:	
Business income	$200,000
Investment income	20,000
	220,000
Deductions:	
Business deductions (nonpreference)	100,000
Investment interest expense	80,000
	180,000

Based on the above figures, the trust has $100,000 of taxable income without regard to items which enter into the computation of excess investment interest and the deduction for distributions. The trust also has $60,000 of excess investment interests, resulting in $40,000 of distributable net income. Thus, $60,000 of the $100,000 of noninvestment income is not subject to current taxation by reason of the excess investment interest.

(*a*) If $40,000 is distributed to the beneficiary, the beneficiary will normally be subject to tax on the full amount received and the "sheltered" portion of the income will remain at the trust level. Thus, none of the excess investment interest item of tax preference is apportioned to the beneficiary.

(*b*) If the beneficiary receives $65,000 from the trust, the beneficiary is still subject to tax on only $40,000 (the amount of the distributable net income) and thus, is considered to have received $25,000 of business income "sheltered" by excess investment interest. Thus, $25,000 of the $60,000 of excess investment interest of the trust is apportioned to the beneficiary.

Example (2). Trust B has $150,000 of net section 1201 gain.

(*a*) If none of the gain is distributed to the beneficiaries, none of the capital gains item of tax preference is apportioned to the beneficiaries.

(*b*) If all or a part of the gain is distributed to the beneficiaries, a proportionate part of the capital gains item of tax preference is apportioned to the beneficiaries. If any of the beneficiaries are corporations the capital gains item of tax preference is adjusted in the hands of the corporations as provided in § 1.58-2(a).

Example (3). Trust C has taxable income of $200,000 computed without regard to depreciation on section 1250 property and the deduction for distributions. The depreciation on section 1250 property held by the trust is $160,000. The trust instrument provides for income to be retained by the trust in an amount equal to the depreciation on the property determined under the straight line method (which method has been used for this purpose for the entire period the trust has held the property) which, in this case is equal to $100,000. The $60,000 excess of the accelerated depreciation of $160,000 over the straight line amount which would have resulted had the property been depreciated under that method for the entire period for which the trust has held the

property is an item of tax preference pursuant to section 57(a)(2). Of the remaining $100,000 of net income of the trust (after the reserve for depreciation), 80 percent is distributed to the beneficiaries. Pursuant to sections 167(h) and 642(e), 80 percent of the remaining $60,000 of depreciation deduction (or $48,000) is taken as a deduction directly by the beneficiaries and "shelters" the income received by the beneficiaries. Thus, the full $48,000 deduction taken by the beneficiaries is "excess accelerated depreciation" on section 1250 property and is an item of tax preference in the hands of the beneficiaries. None of the remaining $12,000 of "excess accelerated depreciation" is apportioned to the beneficiaries since this amount "shelters" income retained at the trust level.

Example (4). G creates a trust the ordinary income of which is payable to his adult son. Ten years from the date of the transfer, corpus is to revert to G. G retains no other right or power which would cause him to be treated as an owner under subpart E of part 1 of subchapter J (section 671 and following). Under the terms of the trust instrument and applicable local law capital gains must be applied to corpus. During the taxable year 1970 the trust has $200,000 income from dividends and interest and a net long-term capital gain of $100,000. Since the capital gain is held or accumulated for future distribution to G, he is treated under section 677(a)(2) as an owner of a portion of the trust to which the gain is attributable. Therefore, he must include the capital gain in the computation of his taxable income in 1970 and the capital gain item of tax preference is treated as being directly received by G. Accordingly, no adjustment is made to the trust's minimum tax exemption by reason of the capital gain.

Example (5). For its taxable year 1971 the trust referred to in example (4) has taxable income of $200,000 computed without regard to depreciation on section 1250 property and the deduction for distributions. The depreciation on section 1250 property held by the trust is $160,000. The trust instrument provides for income to be retained by the trust in an amount equal to the depreciation on the property determined for purposes of the Federal income tax. If the property had been depreciated under the straight line method for the entire period for which the trust held the property the resulting depreciation deduction would have been $100,000. The $60,000 excess is, therefore, an item of tax preference pursuant to section 57(a)(2) and § 1.57-1(d). Since this amount of "income" is held or accumulated for future distributions to G, he is treated under section 677(a)(2) as an owner of a portion of the trust to which such income is attributable. Therefore, section 671 requires that in computing the tax liability of the grantor the income, deductions, and credits against tax of the trust which are attributable to such portion shall be taken into account. Thus, the grantor has received $160,000 of income and is entitled to a depreciation deduction in the same amount. The $60,000 item of tax preference resulting from the excess depreciation is treated as being directly received by G as he has directly received the income sheltered by that preference. Accordingly, no adjustment is made to the trust's minimum tax exemption by reason of such depreciation.

[T.D. 7564, 43 FR 40482, Sept. 12, 1978]

§ 1.58-4 Electing small business corporations.

(a) *In general.* Section 58(d)(1) provides rules for the apportionment of the items of tax preference of an electing small business corporation among the shareholders of such corporation. Section 58(d)(2) provides rules for the imposition of the minimum tax on an electing small business corporation with respect to certain capital gains. For purposes of section 58(d) and this section, the items of tax preference are computed at the corporate level as if section 57 generally applied to the corporation. However, the items of tax preference so computed are treated as items of tax preference of the shareholders of such corporation and not as items of tax preference of such corporation (except as provided in paragraph (c) of this section). The items of tax preference specified in section 57(a)(1) and § 1.57-1(a) (excess investment interest) and section 57(a)(3) and § 1.57-1(c) (accelerated depreciation on section 1245 property subject to a net lease), while generally inapplicable to corporations, are included as items of tax preference in the case of an electing small business corporation.

(b) *Apportionment to shareholders.* (1) The items of tax preference of an electing small business corporation, other than the capital gains item of tax preference described in paragraph (c) of this section, are apportioned pro rata among the shareholders of such corporation in a manner consistent with section 1374(c)(1). Thus, with respect to the items of tax preference of the electing small business corporation, there is to be treated as items of tax preference of each shareholder a

pro rata share of such items computed as follows:

(i) Divide the total amount of such items of tax preference of the corporation by the number of days in the taxable year of the corporation, thus determining the daily amount of such items of tax preference.

(ii) Determine for each day the shareholder's portion of the daily amount of each such item of tax preference by applying to such amount the ratio which the stock owned by the shareholder on that day bears to the total stock outstanding on that day.

(iii) Total the shareholder's daily portions of each such item of tax preference of the corporation for it taxable year.

Amounts taken into account by shareholders in accordance with this paragraph are considered to consist of a pro rata share of each item of tax preference of the corporation. Thus, for example, if the corporation has $50,000 of excess investment interest and $150,000 of excess accelerated depreciation on section 1250 property and a shareholder, in accordance with this paragraph, takes into account $60,000 of the total $200,000 of tax preference items of the corporation, one-fourth ($50,000÷$200,000) of the $60,000, or $15,000, taken into account by the shareholder is considered excess investment interest and three-fourths of the $60,000, or $45,000, is considered excess accelerated depreciation on section 1250 property.

(2) Items of tax preference apportioned to a shareholder pursuant to subparagraph (1) of this paragraph are taken into account by the shareholder for the shareholder's taxable year in which or with which the taxable year of the corporation ends, except that, in the case of the death of a shareholder during any taxable year of the corporation (during which the corporation is an electing small business corporation), the items of tax preference of the corporation for such taxable year are taken into account for the final taxable year of the shareholder.

(c) *Capital gains.* (1) Capital gains of an electing small business corporation, other than those capital gains subject to tax under section 1378, do not result in an item of tax preference at the corporate level since, in applying the formula specified in sections 57(a)(9)(B) and 1.57-1(i)(2), the rate of tax on capital gains (and the resulting tax) at the corporate level is zero. Under section 1375 (a) shareholders of an electing small business corporation take into account the capital gains of the corporation (including capital gains subject to tax under sec. 1378). Therefore, the computation of the capital gains item of tax preference at the shareholder level, with respect to such capital gains, is taken into account automatically by operation of sections 57(a)(9) and 1.57-1(i). To avoid double inclusion of the capital gains item of tax preference by a shareholder with respect to capital gains subject to tax under section 1378, the capital gains item of tax preference which results at the corporate level by reason of section 58 (d)(2) is not treated under section 58 (d)(1) as an item of tax preference of the shareholders of the corporation.

(2) The capital gains item of tax preference of an electing small business corporation subject to the tax imposed by section 1378 is the excess of the amount of tax computed under section 1378(b)(2) over the sum of—

(i) The amount of tax that would be computed under section 1378(b)(2) if the following amount were excluded:

(*a*) That portion of the net section 1201 gain of the corporation described in section 1378(b)(1), or

(*b*) If section 1378(c)(3) applies, that portion of the net section 1201 gain attributable to the property described in section 1378(c)(3), and

(ii) The amount of tax imposed under section 1378 divided by the sum of the normal tax rate and the surtax rate under section 11 for the taxable year.

(3) The principles of this paragraph may be illustrated by the following example.

Example. Corporation X is a calendar year taxpayer and an electing small business corporation. For its taxable year 1971 the corporation has net section 1201 gain of $650,000 and taxable income of $800,000 (including the net section 1201 gain). Although X's election under section 1372(a) has been

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in effect for its three immediately preceding taxable years, X is subject to the tax imposed by section 1378 for 1971 since it has net section 1201 gain (in the amount of $200,000) attributable to property with a substituted basis. The tax computed under section 1378(b)(1) is $187,500 (30 percent of ($650,000 minus $25,000)) and under section 1378(b)(2) is $377,500 (22 percent of $800,000 plus 26 percent of $775,000). By reason of the limitation imposed by section 1378(c) the tax actually imposed by section 1378 is $60,000 (30 percent of $200,000, the net section 1201 gain). The tax computed under section 1378(b)(2) with the modification required under subparagraph (2)(i) of this paragraph is $281,500 (22 percent of $600,000 plus 26 percent of $575,000). Thus, the 1971 capital gains item of tax preference X is $75,000 computed as follows:

1. Tax computed under 1378(b) (2)	$377,500
2. Tax computed under 1378(b) (2) with modification	281,500
3. Excess	96,000
4. Tax actually imposed under 1378	60,000
5. Difference	36,000
6. Normal tax rate plus surtax rate	.48
7. Tax preference (line 5 divided by line 6)	$75,000

In addition each shareholder of X will take into account his distributive share of the $650,000 of net section 1201 gain of X less the taxes paid by X under sections 56 and 1378 on the gain

[T.D. 7564, 43 FR 40483, Sept. 12, 1978]

§ 1.58-5 Common trust funds.

Section 58(e) provides that each participant in a common trust fund (as defined in sec. 584 and the regulations thereunder) is to treat as items of tax preference his proportionate share of the items of tax preference of the fund computed as if the fund were an individual subject to the minimum tax. The participant's proportionate share of the items of tax preference of the fund is determined as if the participant had realized, or incurred, his pro rata share of items of income, gain, loss, or deduction of the fund directly from the source from which realized or incurred by the fund. The participant's pro rata share of such items is determined in a manner consistent with section 1.584-2(c). Items of tax preference apportioned to a participant pursuant to this paragraph are taken into account by the participant for the participant's taxable year in which or with which the taxable year of the trust ends.

[T.D. 7564, 43 FR 40484, Sept. 12, 1978]

§ 1.58-6 Regulated investment companies; real estate investment trusts.

(a) *In general.* Section 58(f) provides rules with respect to the determination of the items of tax preference of regulated investment companies (as defined in sec. 851) and their shareholders and real estate investment trusts (as defined in sec. 856) and their shareholders, or holders of beneficial interest. In general, the items of tax preference of such companies and such trusts are determined at the company or trust level and the items of tax preference so determined (other than the capital gains item of tax preference (secs. 57(a)(9) and 1.57-1(i)) and, in the case of a real estate investment trust, accelerated depreciation on section 1250 property (secs. 57(a)(2) and 1.57-1(b)) are treated as items of tax preference of the shareholders, or holders of beneficial interest, in the same proportion that the dividends (other than capital gains dividends) paid to each such shareholder, or holder of beneficial interest, bear to the taxable income of such company or such trust determined without regard to the deduction for dividends paid. In no case, however, is such proportion to be considered in excess of 100 percent. For example, if a regulated investment company has items of tax preference of $500,000 for the taxable year, none of which resulted from capital gains, and distributes dividends in an amount equal to 90 percent of its taxable income, each shareholder treats his share of 90 percent of the company's items of tax preference, or (a proportionate share of) $450,000, as items of tax preference of the shareholder. The remaining $50,000 constitutes items of tax preference of the company. Amounts treated under this paragraph as items of tax preference of the shareholders, or holders of beneficial interest, are deemed to be derived proportionately from each item of tax preference of the company or trust, other than the capital gains item of tax preference and, in the case of a real estate investment trust, accel-

erated depreciation on section 1250 property. Such amounts are taken into account by the shareholders, or holders of beneficial interest, in the same taxable year in which the dividends on which the apportionment is based are includible in income. The minimum tax exemption of the trust or company shall not be reduced because a portion of the trust's or company's items of tax preference are allocated to the shareholders or holders of beneficial interests.

(b) *Capital gains.* Section 58(g)(1) provides that a regulated investment company or real estate investment trust does not treat as an item of tax preference the capital gains item of tax preference under section 57(a)(9) (and sec. 1.57-1(i)) to the extent that such item is attributable to amounts taken into income by the shareholders of such company under section 852(b)(3) or by the shareholders or holders of beneficial interest of such trust under section 857(b)(3). Thus, such a company or trust computes its capital gains item of tax preference on the basis of its net section 1201 gain less the sum of (1) the capital gains dividend (as defined in sec. 852(b)(3)(C) or sec. 857(b)(3)(C)) for the taxable year of the company or trust plus (2), in the case of a regulated investment company, that portion of the undistributed capital gains designated, pursuant to section 852(b)(3)(D) and the regulations thereunder, by the company to be includible in the shareholder's return as long-term capital gains for the shareholders's taxable year in which the last day of the company's taxable years falls. Amounts treated under section 852(b)(3) or 857(b)(3) as long-term capital gains of shareholders, or holders of beneficial interest, are automatically included, pursuant to sections 57(a)(9) and 1.57-1(i), in the computation of the capital gains item of tax preference of the shareholders, or holders of beneficial interest.

(c) *Accelerated depreciation on section 1250 property.* In the case of a real estate investment trust, all of the items of tax preference resulting from accelerated depreciation on section 1250 property held by the trust (section 57(a)(2) and § 1.57-1(b)) are treated as items of tax preference of the trust, and, thus, none are treated as items of tax preference of the shareholder, or holder of beneficial interest.

[T.D. 7564, 43 FR 40484, Sept. 12, 1978]

§ 1.58-7 Tax preferences attributable to foreign sources; preferences other than capital gains and stock options.

(a) *In general.* Section 58(g)(1) provides that except in the case of the stock options item of tax preference (section 57(a)(6) and § 1.57-1(f)) and the capital gains item of tax preference (section 57(a)(9) and § 1.57-1(i)), items of tax preference which are attributable to sources within any foreign country or possession of the United States shall, for purposes of section 56, be taken into account only to the extent that such items reduce the tax imposed by chapter 1 (other than the minimum tax under section 56) on income derived from sources within the United States. Items of tax preference from sources within any foreign country or possession of the United States reduce the chapter 1 tax on income from sources within the United States to the extent the deduction relating to such preferences, in combination with other foreign deductions, exceed the income from such sources and, in effect, offset income from sources within the United States. Items of tax preference, for this purpose, are determined after application of § 1.57-4 (relating to limitation on amounts treated as items of tax preference). In the case of a taxpayer who deducted foreign taxes under section 164 for a taxable year, the provisions of this section shall be applied) without regard to section 275(a)(4)) as if he had elected the overall foreign tax credit limitation under section 904(a)(2) for such year.

(b) *Preferences attributable to foreign sources*—(1) *Preferences other than excess investment interest.* Except in the case of excess investment interest (see subparagraph (2) of this paragraph), an item of tax preference to which this section applies is attributable to sources within a foreign country or possession of the United States to the extent such item is attributable to a deduction properly al-

locable or apportionable to an item or class of gross income from sources within a foreign country or possession of the United States under the principles of section 862(b), or section 863, and the regulations thereunder. Where, in the case of income partly from sources within the United States and partly from sources within a foreign country or possession of the United States, taxable income is computed before apportionment to domestic and foreign sources, and is then apportioned by processes or formulas of general apportionment (pursuant to section 863(b) and the regulations thereunder), deductions attributable to such taxable income are considered to be proportionately from sources within the United States and within the foreign country or possession of the United States on the same basis as taxable income.

(2) *Excess investment interest*—(i) *Per-country limitation.* (*a*) In the case of a taxpayer on the per-country foreign tax credit limitation under section 904(a) for the taxable year, excess investment interest (as defined in section 57(b)(1)), and the resulting item of tax preference, is attributable to sources within a foreign country or a possession of the United States to the extent that investment interest expense attributable to income from sources within such foreign country or possession of the United States exceeds the net investment income from sources within such foreign country or such possession. For this purpose, net investment income from within a foreign country or possession of the United States is the excess (if any) of the investment income from sources within such country or possession over the investment expenses attributable to income from sources within such country or such possession. For the definition of investment interest expense see section 57(b)(2)(D); for the definition of investment income see section 57(b)(2)(B); for the definition of investment expense see section 57(b)(2)(C).

(*b*) If the taxpayer's excess investment interest computed on a worldwide basis is less than the taxpayer's total separately determined excess investment interest (as defined in this subdivision (*b*)), the amount of the taxpayer's excess investment interest from each foreign country or possession is the amount which bears the same relationship to the taxpayer's excess investment interest from each such country or possession, determined without regard to this subdivision (*b*), as the taxpayer's worldwide excess investment interest bears to the taxpayer's total separately determined excess investment interest. For purposes of this subdivision (*b*), the taxpayer's total separately determined excess investment interest is the sum of the total excess investment interest determined without regard to this subdivision (*b*) plus the taxpayer's excess investment interest from sources within the United States determined in a manner consistent with (*a*) of this subdivision (i).

(ii) *Overall limitation.* In the case of a taxpayer who has elected the overall foreign tax credit limitation under section 904(a)(2) for the taxable year, excess investment interest (as defined in section 57(b)(1)), and the resulting item of tax preference, is attributable to sources within any foreign country or possession of the United States to the extent that investment interest expense attributable to income from such sources exceeds the sum of (*a*) the net investment income from such sources plus (*b*) the excess, if any, of net investment income from sources within the United States over investment interest expense attributable to sources within the United States. For this purpose, net investment income from sources within any foreign country or possession of the United States is the excess (if any) of the investment income from all such sources over the investment expenses attributable to income from such sources. For the definition of investment interest expense see section 57(b)(2)(D) for the definition of investment income see section 57(b)(2)(B); for the definition of investment expense see section 57(b)(2)(C).

(iii) *Allocation of expenses.* The determination of the investment interest expense and investment expenses attributable to a foreign country or possession of the United States is made in

a manner consistent with subparagraph (1) of this paragraph.

(iv) *Attribution of certain interest deductions to foreign sources.* Where net investment income from sources within any foreign country or possession has the effect of offsetting investment interest expense attributable to income from sources within the United States, the deductions for the investment interest expense so offset are, for purposes of § 1.58-7(c) (relating to reduction in taxes on United States source income), treated as deductions attributable to income from sources within the foreign country or possession from which such net investment income is derived. Such an offset will occur where there is an excess of investment interest expense attributable to income from sources within the United States over net investment income from such sources and (*a*) in the case of a taxpayer on the per-country foreign tax credit limitation, an excess of net investment income from sources within a foreign country or possession of the United States over investment interest expense from within such foreign country or possession, or (*b*) in the case of a taxpayer who has elected the overall foreign tax credit limitation, there is an excess of net investment income from sources within foreign countries or possessions of the United States over investment interest expense attributable to income from within such sources.

(v) *Separate limitation on interest income.* Where a taxpayer has income described in section 904(f)(2) (relating to interest income subject to the separate foreign tax credit limitation) or expenses attributable to such income, the determination of the excess investment interest resulting therefrom must be determined separately with respect to such income and the expenses properly allocable or apportionable thereto in the same manner as such determination is made in the case of a taxpayer on the per-country foreign tax credit limitation for the taxable year (see subdivision (i) of this subparagraph).

(vi) *Examples.* The principles of this subparagraph may be illustrated by the following examples in each of which the taxpayer is an individual and a citizen of the United States:

Example (1). The taxpayer's only items of income and deduction relating to excess investment interest are as follows:

	United States	France	Germany	Total
Investment income from sources within	$150,000	$120,000	$180,000	$450,000
Investment expenses relating to income from sources within	(100,000)	(90,000)	(120,000)	(310,000)
Net investment income	50,000	30,000	60,000	140,000
Investment interest expense relating to income from sources within	(110,000)	(70,000)	(50,000)	(230,000)
(Excess) of investment interest expense over net investment income	(60,000)	(40,000)	*10,000	(90,000)

*Excess of net investment income over investment interest expense.

(a) If the taxpayer has elected the overall foreign tax credit limitation, his excess investment interest from sources within any foreign countries or possessions of the United States determined under subdivision (ii) of this subparagraph is computed as follows:

Investment interest:			
French	($70,000)		
German	(50,000)		($120,000)
Net investment income:			
Investment income:			
French	120,000		
German	180,000	$300,000	
Less:			
Investment expenses:			
French	(90,000)		
German	(120,000)	(210,000)	90,000
Excess of U.S. net income over investment interest expenses:			
Total foreign excess investment interest			(30,000)

(b) If the taxpayer is on the per-country foreign tax credit limitation, his excess investment interest from France and Germany determined under subdivision (i)(*a*) of this subparagraph is $40,000 and zero, respectively. Since the taxpayer's worldwide excess investment interest ($90,000) is less than his total separately determined excess investment interest ($60,000 (United States) plus $40,000 (French) plus zero (German), or $100,000), the limitation in subdivision (i)(*b*) of this subparagraph applies and the excess investment interest attributable to France is limited as follows:

Total worldwide excess ($90,000)/Total separately determined excess ($100,000) × French excess ($40,000)=$36,000

The taxpayer's total excess investment interest attributable to sources within any foreign country or possession of the United States is, thus, $36,000 ($36,000 (French) plus zero (German)). The taxpayer's excess investment interest attributable to sources within the United States is $54,000

($90,000/$100,000×$60,000).

Since, in making the latter determination, $6,000 of the $60,000 of U.S. investment interest expense in excess of U.S. net investment income is, in effect, offset by German net investment income, for purposes of § 1.58-7(c), $6,000 of interest deductions attributable to income from sources within the United States are, pursuant to subdivision (iv) of this subparagraph, treated as deductions attributable to income from sources within Germany.

Example (2). Assume the same facts as in example (1) except that the items of income and deduction in Germany and the United States are reversed. The worldwide excess investment interest, thus, remains $90,000 and the items of income and deduction relating to excess investment interest are as follows:

	United States	France	Germany	Total
Investment income from sources within	$180,000	$120,000	$150,000	$450,000
Investment expenses relating to income from sources within	(120,000)	(90,000)	(100,000)	(310,000)
Net investment income	60,000	30,000	50,000	140,000
Investment interest expense relating to income from sources within	(50,000)	(70,000)	(110,000)	(230,000)
(Excess) of investment interest expense over net investment income	10,000	(40,000)	(60,000)	(90,000)

(a) If the taxpayer has elected the overall limitation, his excess investment interest from sources within any foreign countries or possessions of the United States determined under subdivision (ii) of this subparagraph is determined as follows:

Foreign investment interest:			
French	($70,000)		
German	(110,000)		($180,000)
Foreign net investment income:			
French	120,000		
German	150,000	$270,000	
Less:			
Investment expenses:			
French	(90,000)		
German	(100,000)	(190,000)	80,000
Excess of U.S. net investment income over U.S. investment interest expense			10,000
Excess investment interest attributable to foreign sources			(90,000)

(b) If the taxpayer has not elected the overall foreign tax credit limitation, his excess investment interest from France and Germany determined under subdivision (i) of this subparagraph (without regard to the limitation to worldwide excess investment interest) is $40,000 and $60,000 respectively, and his total separately determined excess investment interest is, thus, $10,000. Since the total separately determined excess

would exceed the worldwide excess, the limitation to the worldwide excess in subdivision (i) applies and the excess investment interest is determined as follows:

France:

$90,000/$100,000×$40,000=$36,000

Germany:

$90,000/$100,000×$60,000=$54,000

Total excess investment interest attributable to sources within any foreign countries and possessions—$90,000.

Example (3). Assume the same facts as in example (1) except that the taxpayer, in addition has investment income, investment expenses, and investment interest subject to the separate limitation under section 904(f).

(a) If the taxpayer has elected the overall foreign tax credit limitation, his excess investment interest from sources within any foreign countries or possessions of the United States determined under subdivision (ii) of this subparagraph is the same as in (a) of example (1) of this subdivision (vi). He then treats such amount as separately determined excess investment interest attributable to a single foreign country as determined under subdivision (i) of this subparagraph and proceeds as in (b) of example (1) of this subdivision (vi) treating items of income and deduction subject to section 904(f) and from each separate foreign country or possession separately in making the additional determinations under subdivisions (i) and (iv) of this subparagraph.

(b) If the taxpayer has not elected the overall foreign tax credit limitation, his excess investment interest from sources within any foreign country or possession of the United States would be determined in the same manner as in (b) of example (1) treating items of income and deduction which are subject to section 904(f) and from each separate foreign country or possession separately in making the determinations under subdivisions (i) and (iv) of this subparagraph.

(c) *Reduction in taxes on United States source income*—(1) *Overall limitation*—(i) *In general.* If a taxpayer is on the overall foreign tax credit limitation under section 904(a)(2), the items of tax preference determined to be attributable to foreign sources under paragraph (b) of this section reduce the tax imposed by chapter 1 (other than the minimum tax imposed under section 56) on income from sources within the United States for the taxable year to the extent of the smallest of the following three amounts:

(*a*) Items of tax preference (other than stock options and capital gains) attributable to sources within a foreign country or possession of the United States,

(*b*) The excess (if any) of the total deductions properly allocable or apportionable to items or classes of gross income from sources within foreign countries and possessions of the United States over the gross income from such sources, or

(*c*) Taxable income from sources within the United States.

See § 1.58–7(b)(2)(iv) with respect to the attribution of certain interest deductions to foreign sources in cases involving the excess investment interest item of tax preference.

(ii) *Net operating loss.* Where there is an overall net operating loss for the taxable year, to the extent that the lesser of the amounts determined under (*a*) or (*b*) of subdivision (i) of this subparagraph exceeds the taxpayer's taxable income from sources within the United States (and, therefore do not offset taxable income from sources within the United States for the taxable year) the amount of such excess is treated as "suspense preferences." Suspense preferences are converted to actual items of tax preference, arising in the loss year and subject to the provisions of section 56, as the net operating loss is used in other taxable years, in the form of a net operating loss deduction under section 172, to offset taxable income from sources within the United States. Suspense preferences which, in other taxable years, reduce taxable income from sources within any foreign country or possession of the United States lose their character as suspense preferences and, thus, are never converted into actual items of tax preference. The amount of the suspense preferences which are converted into actual items of tax preference is equal to that portion of the net operating loss attributable to the suspense preferences which offset taxable income from sources within the United States in taxable years other than the loss year. The determination of the component parts of the net operating loss and the determination of the amount

by which the portion of the net operating loss attributable to suspense preferences offsets taxable income from sources within the United States is made on a year-by-year basis in the same order as the net operating loss is used in accordance with section 172(b). Such determination is made by applying deductions attributable to U.S. source income first against such income and deductions attributable to foreign source income first against such foreign source income and in accordance with the following principles:

(*a*) Deductions attributable to items or classes of gross income from sources within the United States offset taxable income from sources within the United States before any remaining portion of the net operating loss;

(*b*) Deductions attributable to items or classes of gross income from sources within foreign countries or possessions of the United States offset taxable income from such sources before any remaining portion of the net operating loss;

(*c*) Deductions described in (*b*) of the subdivision (ii) which are not suspense preferences (referred to in this subparagraph as "other foreign deductions") offset taxable income from sources within foreign countries and possessions of the United States before suspense preferences; and

(*d*) Suspense preferences offset taxable income from sources within the United States before other foreign deductions.

For purposes of the above computations, taxable income is computed with the modifications specified in section 172(b)(2) or section 172(c), whichever is applicable. However, the amount of suspense preferences which are converted into actual items of tax preference in accordance with the above principles is reduced to the extent suspense preferences offset increases in taxable income from sources within the United States due to the modifications specified in section 172(b)(2) or section 172(c). For this purpose, suspense preferences are considered to offset an increase in taxable income due to the section 172(b)(2) modifications only after reducing taxable income computed before the section 172(b)(2) or section 172(c) modifications.

(iii) ***Examples.*** The principles of this subparagraph may be illustrated by the following examples. In each example the taxpayer is an individual citizen of the United States and has elected the overall foreign tax credit limitation. Personal deductions and exemptions are disregarded for purposes of these examples.

Example (1). In 1974, the taxpayer has the following items of income and deduction:

United States taxable income:			
Gross income		$750,000	
Deductions		(250,000)	$500,000
Foreign source loss:			
Gross income		200,000	
Deductions:			
Preference items (excess of percentage depletion over basis)	$550,000		
Other	50,000	(600,000)	(400,000)
Overall taxable income			100,000

Pursuant to subdivision (i) of this subparagraph the smallest of (a) the items of tax preference attributable to the foreign sources ($550,000), (b) the foreign source loss ($400,000), or (c) the taxable income from sources within the United States ($500,000) reduces the tax imposed by chapter 1 (other than the minimum tax) on income from sources within the United States. Thus, $400,000 of the $550,000 of excess depletion is treated as an item of tax preference in 1974 subject to the minimum tax.

Example (2). Assume the same facts as in example (1) except that the gross income from sources within the United States is $350,000 resulting in U.S. taxable income of $100,000 and an overall net operating loss of $300,000. Pursuant to subdivision (i) of this subparagraph, $100,000 of the $550,000 excess depletion would be treated as an item of tax preference in 1974 subject to the

minimum tax. In addition, pursuant to subdivision (ii) of this subparagraph, the excess of the items of tax preference from foreign sources ($550,000) or the foreign source loss ($400,000), whichever is less, over the U.S. taxable income ($100,000), or, in this example, $300,000, is treated as suspense preferences.

(a) If, in 1971, the taxpayer's total items of income and deduction result in $350,000 of taxable income all of which is from sources within the United States, the entire $300,000 net operating loss, all of which is attributable to suspense preferences, is used to offset U.S. taxable income. Accordingly, the full $300,000 of suspense preferences are converted into actual items of tax preference arising in 1974 and are subject to tax under section 56.

(b) If the $350,000 in 1971 is modified taxable income resulting from the denial of a section 1202 capital gains deduction of $175,000 by reason of section 172(b)(2), the $300,000, otherwise treated as actual items of tax preference, is reduced by $125,000, i.e., the extent to which the suspense preferences offset U.S. taxable income attributable to the increase in taxable income resulting from the denial of the section 1202 deduction.

Example (3). In 1974, the taxpayer has the following items of income and deduction:

United States loss:			
Gross income		$75,000	
Deductions		(225,000)	($150,000)
Foreign loss:			
Gross income		400,000	
Deductions:			
Preference items (excess of accelerated depreciation on sec. 1250 property over straight-line amount)	$200,000		
Other	550,000	(750,000)	(350,000)
Overall net operating loss			(500,000)

Since the nonpreference deductions reduce the foreign source income before the preference portion, the $350,000 foreign source loss consists of $200,000 of suspense preferences and $150,000 of other deductions. In 1971, 1972, and 1973 the taxpayer had taxable income from sources within the United States of $100,000, $200,000, and $300,000, respectively and taxable income from sources within foreign countries of $80,000 each year. Of the $200,000 of suspense preferences, $150,000 are converted into actual items of tax preference, subject to the minimum tax in 1974, determined as follows:

[In thousands of dollars]

Year—Explanation	Taxable income		U.S. deductions	Foreign deductions	
	U.S. source	Foreign source		Suspense preferences	Other
1971 End of year balance before section 58(g) computations	100	80	150	200	150
1. U.S. deductions against U.S. income	(100)		(100)		
2. Other foreign deductions against foreign income		(80)			(80)
1972 End of year balance before section 58(g) computations	200	80	50	200	70
1. U.S. deductions against U.S. income	(50)		(50)		
2. Other foreign deductions against foreign income		(70)			(70)
3. Suspense preferences against foreign income		(10)		(10)	
4. Suspense preferences against U.S. income	*(150)			*(150)	
1973 End of year balance before section 58(g) computations	300	80		40	
1. U.S. deductions against U.S. income			Not applicable		
2. Other foreign deductions against foreign income			Not applicable		
3. Suspense preference against foreign income		(40)		(40)	

[In thousands of dollars]

Year—Explanation	Taxable income		U.S. deductions	Foreign deductions	
	U.S. source	Foreign source		Suspense preferences	Other
4. Suspense preferences against U.S. income			Not applicable		
Balances	300	40			

*Suspense preferences converted to actual items of tax preference.

Example (4). In 1970, the taxpayer's total items of income and deduction, all of which are attributable to foreign sources, are as follows:

Foreign loss:		
Gross income		$400,000
Deductions:		
Preferences (excess of accelerated depreciation on section 1250 property over straight-line)	$200,000	
Net operating loss		350,000

Pursuant to subdivision (i) of this subparagraph, none of the preferences attributable to foreign sources reduce the tax imposed by chapter 1 (other than the minimum tax) on taxable income from sources within the United States. Pursuant to subdivision (ii) of this subparagraph, the $200,000 portion of the net operating loss resulting from the excess accelerated depreciation constitutes suspense preferences. No part of the net operating loss that is carried back to previous years is reduced in such previous years. In 1971 and 1972, the taxpayer's income (before the net operating loss deduction) consists of the following:

1971 taxable income:	
United States	$160,000
Foreign	70,000
Total	230,000
1972 taxable income:	
United States	25,000
Foreign	105,000
Total	130,000

(a) In 1971, the conversion of suspense preferences into actual items of tax preference under section 58(g) (and this paragraph) and the imposition of the minimum tax on 1970 items of tax preference under section 56(b) and (§ 1.56–2) are determined as follows:

Conversion of suspense preferences:

1970 NET OPERATING LOSS

[In thousands of dollars]

	U.S. taxable income	Foreign taxable income	U.S. deductions	Suspense preferences	Other foreign deductions
	$160	$70		$200	$150
1. U.S. deductions against U.S. income			Not applicable		
2. Other foreign deductions against foreign income		70			(70)
3. Suspense preference against foreign income			Not applicable		
4. Suspense preference against U.S. income	*(160)			(160)	
Balance to 1972				40	80

*Suspense preferences converted into actual items of tax preference.

Imposition of minimum tax on 1970 items of tax preference:

1970 NET OPERATING LOSS

[In thousands of dollars]

	1971 taxable income	Nonpreference portion	Preference portion	Suspense portion
	$230	$150		$200
1. 1971 conversion of suspense preferences pursuant to sec. 58(g)		[1] 30	$130	(160)
Adjusted NOL		180	130	40
2. Nonpreference portion against taxable income	(180)	(180)		
3. Preference portion against taxable income	[2] (50)		(50)	
Balance to 1972			80	40

[1] Represents the 1970 minimum tax exemption.
[2] Imposition of 1970 minimum tax (10 pct × $50,000 = $5,000).

(*b*) In 1972, the conversion of suspense preferences into actual items of tax preferences under section 58(g) (and this paragraph) and the imposition of the minimum tax on 1970 items of tax preference under section 56(b) (and § 1.56-2) are determined as follows:

Conversion of suspense preferences:

1970 NET OPERATING LOSS

[In thousands of dollars]

	U.S. taxable income	Foreign taxable income	U.S. deductions	Suspense preferences	Other foreign deductions
	$25	$105		$40	$80
1. U.S. deduction against U.S. income		Not applicable			
2. Other foreign deductions against foreign income.		(80)			(80)
3. Suspense preferences against foreign income.		(25)		(25)	
4. Suspense preference against U.S. income	[1] (15)			(15)	
Balance	10				

[1] Suspense preferences converted into actual items of tax preference.

Imposition of minimum tax on 1970 items of tax preference:

1970 NET OPERATING LOSS

[In thousands of dollars]

	1972 taxable income	Nonpreference portion	Preference portion	Suspense portion
	$130		$80	$40
1. 1972 conversion of suspense preferences pursuant to sec. 58(g)		$25	15	(40)
Adjusted NOL		25	95	
2. Nonpreference portion against taxable income	(25)	(25)		
3. Preference portion against taxable income	[1] (95)		(95)	
Balance	10			

[1] Imposition of 1970 minimum tax (10 pct × $95,000 = $9,500).

(2) ***Per-country limitation*****—(i)** ***In general.*** **If a taxpayer is on the per-country foreign tax credit limitation for the taxable year, the amount by which the items of tax preference to which this section applies reduce the tax imposed by chapter 1 (other than the minimum tax under section 56) on income from sources within the United States is determined separately with respect to each foreign country or possession of the United States. Such determination is made in a manner consistent with subparagraph (1) of this paragraph as modified in subdivision (ii) of this subparagraph.**

In applying subparagraph (1)(i) of this paragraph to a taxpayer on the per-country limitation, if the total potential preference amounts (as defined in this subdivision (i)) exceed the taxpayer's taxable income from sources within the United States, then, for purposes of subparagraph (1)(i)(*c*) of this paragraph (relating to the U.S. taxable income limitation on the amount treated as a reduction of U.S. taxable income), the taxable income from sources within the United States which is reduced by potential preference amounts with respect to each foreign country or possession is an amount which bears the same relationship to such income as the potential preference amount with respect to such foreign country or possession bears to the total of the potential preference amounts with respect to all foreign countries and possessions. For purposes of this subparagraph, the potential preference amount with respect to a foreign country or possession is the lesser of the amount of foreign source preference (described in subparagraph (1)(i)(*a*) of this paragraph) attributable to such country or possession or the amount of foreign source loss (described in subparagraph (1)(i)(*b*) of this paragraph) attributable to such country or possession.

(ii) *Net operating loss.* Where there is an overall net operating loss for the taxable year and the total of the potential preference amounts with respect to all foreign countries and possessions exceeds the taxpayer's taxable income from sources within the United States, the amount of such excess is treated as "suspense preferences". The suspense preferences are converted into actual items of tax preference, arising in the loss year and subject to the provisions of section 56, as the net operating loss is used in other taxable years, in the form of a net operating loss deduction under section 172, to offset taxable income from sources within the United States. Suspense preferences attributable to a foreign country or possession which, in other taxable years, reduce taxable income from sources within such country or possession or offset taxable income from sources within any other foreign country or possession lose their character as suspense preferences and, thus, are never converted into actual items of tax preference. The amount of the suspense preferences which are converted into actual items of tax preference is equal to that portion of the net operating loss attributable to the suspense preferences which offsets taxable income from sources within the United States in taxable years other than the loss year. The determination of the component parts of the net operating loss and the determination of the amount by which the portion of the net operating loss attributable to the suspense preferences offsets taxable income from sources within the United States is made on a year-by-year basis in the same order as the net operating loss is used in accordance with section 172(b). Such determination is made by applying deductions attributable to United States source income first against such income and applying deductions attributable to income from sources within a foreign country or possession of the United States first against income from sources within such country or possession and in accordance with the following principles:

(*a*) Deductions attributable to items or classes of gross income from sources within the United States offset taxable income from sources within the United States before any remaining deductions;

(*b*) Deductions attributable to items or classes of gross income from sources within any foreign country or possession of the United States which are not suspense preferences (referred to in this paragraph as "other foreign deductions") offset taxable income from sources within such country or possession before any remaining deductions;

(*c*) Suspense preferences attributable to items or classes of gross income from sources within a foreign country or possession offset any remaining taxable income from sources within such foreign country or possession after application of (*b*) of this subdivision (ii) before any remaining deductions;

(*d*) Suspense preferences from each foreign country and possession (remaining after application of (*c*) of this subdivision (ii)) offset taxable income

from sources within the Unted States (remaining after application of (*a*) of this subdivision (ii)) before other foreign deductions pro rata on the basis of the total of such suspense preferences;

(*e*) Other foreign deductions from each foreign country and possession (remaining after application of (*b*) of this subdivision (ii)) offset taxable income from sources within the United States (remaining after application (*a*) and (*b*) of this subdivision (ii)) pro rata on the basis of the total of such other foreign deductions;

(*f*) Deductions attributable to income from sources within the United States (remaining after application of (*a*) of this subdivision (ii)) offset taxable income from sources within any foreign country or possession before any foreign deductions;

(*g*) Other foreign deductions from each foreign country and possession (remaining after application of (*b*) and (*e*) of this subdivision (ii)) offset taxable income from sources within any other foreign countries or possessions (remaining after application of (*f*) of this subdivision (ii)) pro rata on the basis of the total of such other foreign deductions; and

(*h*) Suspense preferences (remaining after the application of (*c*) and (*d*) of this subdivision (ii)) offset taxable income from sources within any foreign country or possession (remaining after the application of (*f*) and (*g*) of this subdivision (ii)) pro rata on the basis of the total of such suspense preferences.

For purposes of the above computations, taxable income is computed with the modifications specifed in section 172(b)(2) or section 172(c), whichever is applicable. However, the amount of suspense preferences which are converted into actual items of tax preference in accordance with the above principles is reduced to the extent the suspense preferences offset increases in taxable income from sources within the United States due to the modifications specified in section 172(b)(2) or section 172(c). For this purpose, suspense preferences are considered to offset an increase in taxable income due to section 172(b)(2) or section 172(c) modifications only after reducing taxable income computed before such modifications.

(iii) *Examples.* The principles of this subparagraph may be illustrated by the following examples in each of which the per-country foreign tax credit limitation is applicable. For purposes of these examples, personal deductions and exemptions are disregarded.

Example (1). The taxpayer has the following items of income and deduction for the taxable year 1971:

	United States	France	Germany	United Kingdom
Gross income	$180,000	$165,000	$50,000	$75,000
Deductions:				
Preference				(45,000)
Other	(120,000)	(125,000)	(80,000)	(100,000)
Taxable income (or loss)	60,000	40,000	(30,000)	(70,000)

(a) Pursuant to subdivision (i) of this subparagraph, the potential preference amount in the case of the United Kingdom is the lesser of the preferences attributable to the United Kingdom ($45,000) or the excess of deductions over gross income from sources within the United Kingdom ($70,000) and the potential preference amounts in the case of France and Germany are zero in both cases since the preferences attributable to both countries are zero. Since the total potential preference amounts ($45,000) is less than the taxable income from sources within the United States ($60,000), no modification of U.S. taxable income is required. Thus, the amount by which the U.K. preferences reduce the tax on taxable income from sources within the United States, determined in a manner consistent with subparagraph (1)(i) of this paragraph, is the smallest of (1) the items of tax preference attributable to the United Kingdom ($45,000), (2) the excess of deductions over gross income attributable to the United Kingdom ($70,000), or (3) taxable income from sources within the United States

($60,000). The full $45,000 of U.K. preference items are, therefore, taken into account as items of tax preference in 1971 and subject to the minimum tax. Since there is no net operating loss, subdivision (ii) of this subparagraph does not apply.

(b) If the French taxable income is $15,000 instead of $40,000, a $25,000 net operating loss (on a worldwide basis) results. The determination of the foreign preference items taken into account pursuant to subdivision (i) of this subparagraph is the same as in (a) of this example. Subdivision (ii) of this subparagraph again does not apply since the total potential preference amounts ($45,000) is less than the U.S. taxable income ($60,000).

Example (2). For the taxable year 1972, the taxpayer has a net operating loss of $35,000 consisting of the following items of income and deduction:

	United States	France	Germany	United Kingdom	Belgium
Gross income	$250,000	$50,000	$60,000	$5,000	$45,000
Deductions:					
Preferences		(35,000)	(70,000)	(95,000)	
Other	(100,000)	(75,000)	(30,000)		(40,000)
Taxable income (or loss)	150,000	(60,000)	(40,000)	(90,000)	5,000

(a) Pursuant to subdivision (i) of this subparagraph the potential preference amount with respect to each country is the lesser of the amount shown as preferences with respect to such country or the amount of the loss from such country. Thus, the potential preference amounts in this case are:

France	$35,000
Germany	40,000
United Kingdom	90,000
Belgium	0
Total	165,000

Since the total of the potential preference amounts exceeds the U.S. taxable income, in applying the principles of subparagraph (1)(i) of this paragraph, U.S. taxable income which is reduced by potential preference amounts with respect to each country is a pro-rata amount based on the total potential preference amounts as follows:

France (35,000/165,000×$150,000)—$31,818
Germany (40,000/165,000×$150,000)—$36,364
United Kingdom (90,000/165,000×$150,000)— $81,818
Belgium (0/165,000×$150,000)—$0
Total—$150,000

The amount by which the foreign preference items offset U.S. taxable income pursuant to subdivision (i) of this subparagraph is then determined as follows:

	(a) Preferences	(b) Loss	(c) U.S. taxable income	(d) Smallest of (a), (b), or (c)
France	$35,000	$60,000	$81,818	$31,818
Germany	70,000	40,000	36,364	36,364
United Kingdom	95,000	90,000	81,818	81,818
Belgium				
Total				150,000

Thus $150,000 of the total foreign preference items will be taken into account pursuant to subdivision (i) of this subparagraph as items of tax preference in 1972 and subject to the provisions of section 56.

(b) Pursuant to subdivision (ii) of this subparagraph, the 1972 net operating loss of $35,000 will consist of suspense preferences of $15,000 and other foreign deductions of $20,000 attributable to each foreign country as shown below and determined as follows:

Explanation	Deductions						
	United States	France		Germany		United Kingdom preferences	Belgium other
		Preferences	Other	Preferences	Other		
	$100,000	$35,000	$75,000	$70,000	$30,000	$95,000	$40,000
1. U.S. deductions against U.S. income ($250,000)	(100,000)						
2. Other foreign deductions against foreign income (per-country) [1]			(50,000)		(30,000)		(40,000)
3. Suspense preferences against remaining foreign income (per-country)				(30,000)		(5,000)	
4. Suspense preferences against remaining U.S. income:							
France (35,000/165,000 × $150,000)		(31,818)					
Germany (40,000/165,000 × $150,000)				(36,364)			
U.K. (90,000/165,000 × $150,000)						(81,818)	
5. Other foreign deductions against remaining U.S. income (0)	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
6. U.S. deductions against other foreign income	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
7. Other foreign deductions against remaining foreign income ($5,000)			(5,000)				
8. Suspense preferences against remaining foreign income (0):	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Balance (components of NOL)		3,182	20,000	3,636		8,182	

NOTE: N.A. means Not applicable.

[1] Foreign income amounts before step 2 are: France—$50,000; Germany—$60,000; United Kingdom—$5,000; Belgium—$45,000.

Example (3). In 1973, the taxpayer has taxable income (computed without regard to the net operating loss deduction) from the following sources and in the following amounts:

United States	France	Germany	United Kingdom
$100,000	$60,000	$20,000	$30,000

In addition, the taxpayer has a net operating loss deduction of $235,000 resulting from a 1972 net operating loss consisting of the following amounts:

Deductions attributable to income from sources within the United States $25,000
Suspense preferences attributable to income from sources within France $75,000
Deductions other than suspense preferences attributable to income from sources within France $85,000
Deductions other than suspense preferences attributable to sources within the Netherlands $50,000

(*a*) Pursuant to subdivision (ii) of this subparagraph, the converted suspense preferences and the remaining portions of the 1972 net operating loss carried over to 1974 are computed as follows:

[In thousands of dollars]

	1973 income				1972 net operating loss			
	United States	France	Germany	United Kingdom	United States	French suspense preferences	French other deductions	Dutch other deductions
	100	60	20	30	25	75	85	50
U.S. deductions against U.S. income	(25)				(25)			
Other foreign deductions against foreign income (per-country)		(60)					(60)	
Suspense preferences against remaining foreign income (per-country)	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Suspense preferences against remaining U.S. income	([1] 75)					(75)		
Other foreign deductions against remaining U.S. income	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.

[In thousands of dollars]

	1973 income				1972 net operating loss			
	United States	France	Germany	United Kingdom	United States	French suspense preferences	French other deductions	Dutch other deductions
U.S. deductions against remaining foreign income	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Other foreign deductions against remaining foreign income:								
French (25,000/75,000 × $50,000)			(16.7)				(16.7)	
Dutch (50,000/75,000 × $50,000)			(33.3)					(33.3)
Suspense preferences against remaining foreign income	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Balance (1972 carryover to 1974)							8.3	16.7

NOTE: N.A. means Not applicable.

[1] Suspense preferences converted to actual items of tax preference.

(*b*) If, in 1972, there had been no items of tax preference without regard to the suspense preferences, the conversion of the suspense preferences in 1973 would result in a 1972 minimum tax liability under section 56(a) of $4,500 (10 percent × ($75,000 − $30,000)), all of which would have been deferred by reason of section 56(b). Further, by application of section 56(b) and § 1.56-2, $20,000 of the $45,000 preference portion of the 1972 net operating loss would be treated as having reduced taxable income in 1973 resulting in the imposition in 1973 of $2,000 of the deferred 1972 minimum tax liability.

(3) *Separate limitation under section 904(f).* In the case of a taxpayer subject to the separate limitation on interest income under section 904(f), the provisions of this paragraph shall be applied in the same manner as in subparagraph (2) of this paragraph. If the taxpayer has elected the overall foreign tax credit limitation, subparagraph (2) of this paragraph shall be applied as if all income from sources within any foreign countries or possessions of the United States and deductions relating to income from such sources other than income or deductions subject to the separate limitation under section 904(f) were from a single foreign country.

(4) *Carryover of excess taxes.* For rules relating to carryover of excess taxes described in paragraph (1) of section 56(c) when suspense preferences are converted to actual items of tax preference, see § 1.56-5(f).

(5) *Character of amounts.* Where the amounts from sources within a foreign country or possession of the United States (or all such countries or possessions in the case of a taxpayer who has elected the overall foreign tax credit limitation) which are treated as reducing chapter 1 tax on income from sources within the United States or as suspense preferences are less than the total items of tax preference described in subparagraph (1)(i)(*a*) of this paragraph attributable to such sources, the amounts so treated are considered derived proportionately from each such item of tax preference.

[T.D. 7564, 43 FR 40484, Sept. 12, 1978]

§ 1.58–8 Capital gains and stock options.

(a) *In general.* Section 58(g)(2) provides that the items of tax preference specified in section 57(a)(6), and § 1.57-1(b) (stock options), and section 57(a)(9), and § 1.57-1(i) (capital gains), which are attributable to sources within any foreign country or possession of the United States shall not be taken into account as items of tax preference if, under the tax laws of such country or possession, preferential treatment is not accorded:

(1) In the case of stock options, to the gain, profit, or other income realized from the transfer of shares of stock pursuant to the exercise of an option which is under United States tax law a qualified or restricted stock option (under section 422 or section 424); and

(2) In the case of capital gains, to gain from the sale or exchange of capital assets (or property treated as capi-

tal assets under United States tax law).

Where capital gains are not accorded preferential treatment within a foreign country, capital losses as well as capital gains from such country are not taken into account for purposes of the minimum tax.

(b) *Source of capital gains and stock options.* Generally, in determining whether the capital gain or stock option item of tax preference is attributable to sources within any foreign country or possession of the United States, the principles of sections 861-863 and the regulations thereunder are applied. Thus, the stock option item of tax preference, representing compensation for personal services, is attributable, in accordance with § 1.861-4, to sources within the country in which the personal services were performed. Where the capital gain item of tax preference represents gain from the purchase and sale of personal property, such gain is attributable, in accordance with § 1.861-7, entirely to sources within the country in which the property is sold. In accordance with paragraph (c) of § 1.861-7, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred.

(c) *Preferential treatment.* For purposes of this section, gain, profit, or other income is accorded preferential treatment by a foreign country or possession of the United States if (1) recognition of the income, for foreign tax purposes, is deferred beyond the taxpayer's taxable year or comparable period for foreign tax purposes which coincides with the taxpayer's U.S. taxable year in cases where other items of profit, gain, or other income may not be deferred; (2) it is subject to tax at a lower effective rate (including no rate of tax) than other items of profit, gain, or other income, by means of a special rate of tax, artifical deductions, exemptions, exclusions, or similar reductions in the amount subject to tax; (3) it is subject to no significant amount of tax; or (4) the laws of the foreign country or possession by any other method provide tax treatment for such profit, gain, or other income more beneficial than the tax treatment otherwise accorded income by such country or possession. For the purpose of the preceding sentence, gain, profit, or other income is subject to no significant amount of tax if the amount of taxes imposed by the foreign country or possession of the United States is equal to less than 2.5 percent of the gross amount of such income.

(d) *Examples.* The principles of this section may be illustrated by the following examples:

Example (1). The Bahamas imposes no income tax on individuals or corporations, whether resident or nonresident. Since capital gains are subject to no tax in the Bahamas, capital gains are considered to be accorded preferential treatment and will be taken into account for purposes of the minimum tax.

Example (2). In France, except in certain cases involving the sale of large blocks of stock, a nonresident individual is not subject to tax on isolated capital gains transactions. Since such capital gains are not subject to tax in France, they are considered to be accorded preferential treatment irrespective of the treatment accorded other capital gains in France and such gains will be taken into account for purposes of the minimum tax.

Example (3). In Germany, in the case of the sale within 1 taxable year of 1 percent or more of the shares of a corporation in which an individual taxpayer is regarded as holding a substanital interest, the gains on the sale of the large block of stock will be taxed as extraordinary income at one-half the ordinary income tax rate. Since these gains are taxed as a reduced rate of tax in comparison to other income, they are considered to be accorded preferential treatment and will be taken into account for purposes of the minimum tax.

Example (4). In Belgium, gains derived by an individual in the course of regular speculative transactions are taxed as ordinary income, but with an upper limit of 30 percent. Rates of tax on individuals in Belgium range from approximately 30 percent to approximately 60 percent. Since the gains on speculative transactions are taxed at a maximum rate which is more beneficial then the rates accorded to other income, such gains are considered to be accorded

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preferential treatment and will be taken into account for purposes of the minimum tax.

Example (5). In France, gains derived by a company on the sale of fixed assets held for less than 2 years are treated as short-term gains. The excess of short-term gains in any fiscal year is taxed at the full company tax rate of 50 percent. However, this tax may be paid in equal portions over the 5 years immediately following the realization of such short-term gains. Since recognition of the short-term gains for tax purposes is subject to deferral over a 5-year period, such gains are considered to be accorded preferential treatment and will be taken into account for purposes of the minimum tax.

Example (6). Also in France, in the case of the sale or exchange by a company of depreciable assets and nondepreciable asset owned for at least 2 years, the excess of long-term capital gains over long-term capital losses in a fiscal year is subject to an immediate tax at the reduced rate of 10 percent. Such excess, reduced by the 10-percent tax, is carried in a special reserve account on the taxpayer's books. If the excess is reinvested in other fixed asset within a stated period, no further tax is due. If the amounts in the special reserve are distributed, they will be treated as ordinary income for the fiscal year in which the distribution is made. Since such gains (other than those distributed in the same fiscal year they are realized) are subject to deferral or a reduced rate of tax, they are (except to the extent distributed in the year of realization) considered to be accorded preferential treatment and are taken into account for purposes of the minimum tax.

Example (7). In Sweden, in the case of gains derived by an individual on the sale of shares or bonds held for 5 years or less, 25 percent of the gains are taxed if the holding period is 4 to 5 years, 50 percent of the gain is taxed if the holding period is 3 to 4 years, and 75 percent of the gain is taxed if the holding period is 2 to 3 years. The gain is fully taxable at ordinary income rates if held for less than 2 years. Thus, gains on shares or bonds held for 2 years or more are considered accorded preferential treatment in Sweden since they are either subject to exemption or treatment comparable to the U.S. capital gains deduction and are taxed at a reduced rate. Thus, such gains are taken into account for purposes of the minimum tax.

Example (8). Pursuant to Article XIV of the United States-United Kingdom Income Tax Convention, a resident of the United States is exempt from United Kingdom tax on most capital gains. Since such capital gains are exempt from United Kingdom taxation, they are considered to be accorded preferential treatment and are taken into account for purposes of the minimum tax.

Example (9). An individual resident of the United States, is desirous of selling his stock in a corporation listed on the New York Stock Exchange. He requests the stock certificates from his broker in the United States, travels to a foreign country, delivers the certificates to a broker in that country, and has the foreign broker execute the sale which takes place on the New York Stock Exchange. Since the sale was consummated in the United States, pursuant to paragraph (b) of this section and § 1.861-7, the resulting capital gain item of tax preference is attributable to sources within the United States.

Example (10). Two individuals, both residing in the United States, negotiate and reach agreement in New York City for the sale of stock of a closed corporation. Prior to the transfer of the stock, in order to avoid imposition of the minimum tax, both individuals travel to a foreign country which does not accord preferential treatment to capital gains, but imposes a 5-percent rate of income tax which would be fully creditable against U.S. tax under sections 901 and 904 if the capital gains were sourced in that country. The stock is actually transferred and consideration paid in the foreign country. Since the primary purpose of consummating the sale in the foreign country was the avoidance of tax, pursuant to paragraph (b) of this section, and § 1.861-7(c), the resulting capital gain item of tax preference will be considered attributable to sources within the country in which the substance of sale took place or, in this case, the United States.

[T.D. 7564, 43 FR 40492, Sept. 12, 1978]

COMPUTATION OF TAXABLE INCOME

DEFINITION OF GROSS INCOME, ADJUSTED GROSS INCOME, AND TAXABLE INCOME

§ 1.61-1 Gross income.

(a) *General definition.* Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash. Section 61 lists the more common items of gross income for purposes of illustration. For purposes of further illustration, § 1.61-14 mentions several miscellaneous items of gross income not listed specifically in section 61. Gross

income, however, is not limited to the items so enumerated.

(b) *Cross references.* Cross references to other provisions of the Code are to be found throughout the regulations under section 61. The purpose of these cross references is to direct attention to the more common items which are included in or excluded from gross income entirely, or treated in some special manner. To the extent that another section of the Code or of the regulations thereunder, provides specific treatment for any item of income, such other provision shall apply notwithstanding section 61 and the regulations thereunder. The cross references do not cover all possible items.

(1) For examples of items specifically included in gross income, see part II (section 71 and following), subchapter B, chapter 1 of the Code.

(2) For examples of items specifically excluded from gross income, see part III (section 101 and following), subchapter B, chapter 1 of the Code.

(3) For general rules as to the taxable year for which an item is to be included in gross income, see section 451 and the regulations thereunder.

§ 1.61-2 Compensation for services, including fees, commissions, and similar items.

(a) *In general.* (1) Wages, salaries, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses (including Christmas bonuses), termination or severance pay, rewards, jury fees, marriage fees and other contributions received by a clergyman for services, pay of persons in the military or naval forces of the United States, retired pay of employees, pensions, and retirement allowances are income to the recipients unless excluded by law. Several special rules apply to members of the Armed Forces, Coast and Geodetic Survey, and Public Health Service of the United States; see paragraph (b) of this section.

(2) The Code provides special rules including the following items in gross income:

(i) Distributions from employees' trusts, see sections 72, 402, and 403, and the regulations thereunder;

(ii) Compensation for child's services (in child's gross income), see section 73 and the regulations thereunder;

(iii) Prizes and awards, see section 74 and the regulations thereunder.

(3) Similarly, the Code provides special rules excluding the following items from gross income in whole or in part:

(i) Gifts, see section 102 and the regulations thereunder;

(ii) Compensation for injuries or sickness, see section 104 and the regulations thereunder;

(iii) Amounts received under accident and health plans, see section 105 and the regulations thereunder;

(iv) Scholarship and fellowship grants, see section 117 and the regulations thereunder;

(v) Miscellaneous items, see section 122.

(b) *Members of the Armed Forces, Coast and Geodetic Survey, and Public Health Service.* Subsistence and uniform allowances granted commissioned officers, chief warrant officers, warrant officers, and enlisted personnel of the Armed Forces, Coast and Geodetic Survey, and Public Health Service of the United States, and amounts received by them as commutation of quarters, are to be excluded from gross income. Similarly, the value of quarters or subsistence furnished to such persons is to be excluded from gross income. For the exclusion from gross income of—

(1) Disability pensions, see section 104 (a) (4) and the regulations thereunder;

(2) Mustering-out payments, see section 113 and the regulations thereunder;

(3) Miscellaneous items, see section 122.

However, the per diem allowance in lieu of subsistence and the mileage allowance received by such persons while in a travel status or on temporary duty away from their permanent stations shall be included in their gross income.

(c) *Payment to charitable, etc., organization on behalf of person rendering services.* The value of services is not includible in gross income when such services are rendered directly and gra-

tuitously to an organization described in section 170(c). Where, however, pursuant to an agreement or understanding, services are rendered to a person for the benefit of an organization described in section 170(c) and an amount for such services is paid to such organization by the person to whom the services are rendered, the amount so paid constitutes income to the person performing the services.

(d) *Compensation paid other than in cash*—(1) *In general.* Except as otherwise provided in paragraph (d)(6)(i) of this section (relating to certain property transferred after June 30, 1969), if services are paid for in property, the fair market value of the property taken in payment must be included in income as compensation. If services are paid for in exchange for other services, the fair market value of such other services taken in payment must be included in income as compensation. If the services are rendered at a stipulated price, such price will be presumed to be the fair market value of the compensation received in the absence of evidence to the contrary. For special rules relating to certain options received as compensation, see §§ 1.61-15, 1.83-7, and section 421 and the regulations thereunder. For special rules relating to premiums paid by an employer for an annuity contract which is not subject to section 403(a), see section 403(c) and the regulations thereunder and § 1.83-8(a). For special rules relating to contributions made to an employees' trust which is not exempt under section 501, see section 402(b) and the regulations thereunder and § 1.83-8(a).

(2) *Property transferred to employee or independent contractor.* (i) Except as otherwise provided in section 421 and the regulations thereunder and § 1.61-15 (relating to stock options), and paragraph (d)(6)(i) of this section, if property is transferred by an employer to an employee or if property is transferred to an independent contractor, as compensation for services, for an amount less than its fair market value, then regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value at the time of the transfer is compensation and shall be included in the gross income of the employee or independent contractor. In computing the gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of such difference included in gross income

(ii) (*a*) *Cost of life insurance on the life of the employee.* Generally, life insurance premiums paid by an employer on the life of his employee where the proceeds of such insurance are payable to the beneficiary of such employee are part of the gross income of the employee. However, the amount includible in the employee's gross income is determined with regard to the provisions of section 403 and the regulations thereunder in the case of an individual contract issued after December 31, 1962, or a group contract, which provides incidental life insurance protection and which satisfies the requirements of section 401(g) and § 1.401-9, relating to the nontransferability of annuity contracts. For the special rules relating to the includibility in an employee's gross income of an amount equal to the cost of certain group term life insurance on the employee's life which is carried directly or indirectly by his employer, see section 79 and the regulations thereunder. For special rules relating to the exclusion of contributions by an employer to accident and health plans for the employee, see section 106 and the regulations thereunder.

(*b*) *Cost of group-term life insurance on life of spouse or children of an employee.* Generally, the cost (determined under paragraph (d)(2) of § 1.79-3) of group-term life insurance on the life of the spouse or children of an employee paid by the employee's employer is part of the gross income of the employee. However, such cost is not required to be included in the employee's gross income if it is merely incidental. Such cost shall be considered incidental if the amount of such insurance payable upon the death of a spouse or of a child does not exceed $2,000.

(3) *Meals and living quarters.* The value of living quarters or meals which an employee receives in addition to his

salary constitutes gross income unless they are furnished for the convenience of the employer and meet the conditions specified in section 119 and the regulations thereunder. For the treatment of rental value of parsonages or rental allowance paid to ministers, see section 107 and the regulations thereunder; for the treatment of statutory subsistence allowances received by police, see section 120 and the regulations thereunder.

(4) *Stock and notes transferred to employee or independent contractor.* Except as otherwise provided by section 421 and the regulations thereunder and § 1.61-15 (relating to stock options), and paragraph (d)(6)(i) of this section, if a corporation transfers its own stock to an employee or independent contractor as compensation for services, the fair market value of the stock at the time of transfer shall be included in the gross income of the employee or independent contractor. Notes or other evidences of indebtedness received in payment for services constitute income in the amount of their fair market value at the time of the transfer. A taxpayer receiving as compensation a note regarded as good for its face value at maturity, but not bearing interest, shall treat as income as of the time of receipt its fair discounted value computed at the prevailing rate. As payments are received on such a note, there shall be included in income that portion of each payment which represents the proportionate part of the discount originally taken on the entire note.

(5) *Property transferred on or before June 30, 1969, subject to restrictions.* Notwithstanding paragraph (d) (1), (2), or (4) of this section, if any property is transferred after September 24, 1959, by an employer to an employee or independent contractor as compensation for services, and such property is subject to a restriction which has a significant effect on its value at the time of transfer, the rules of § 1.421-6(d)(2) shall apply in determining the time and the amount of compensation to be included in the gross income of the employee or independent contractor. This (5) is also applicable to transfers subject to a restriction which has a significant effect on its value at the time of transfer and to which § 1.83-8(b) (relating to transitional rules with respect to transfers of restricted property) applies. For special rules relating to options to purchase stock or other property which are issued as compensation for services, see § 1.61-15 and section 421 and the regulations thereunder.

(6) *Certain property transferred, premiums paid, and contributions made in connection with the performance of services after June 30, 1969*—(i) *Exception.* Paragraph (d) (1), (2), (4), and (5) of this section and § 1.61-15 do not apply to the transfer of property (as defined in § 1.83-3(e)) after June 30, 1969, unless § 1.83-8 (relating to the applicability of section 83 and transitional rules) applies. If section 83 applies to a transfer of property, and the property is not subject to a restriction that has a significant effect on the fair market value of such property, then the rules contained in paragraph (d) (1), (2), and (4) of this section and § 1.61-15 shall also apply to such transfer to the extent such rules are not inconsistent with section 83.

(ii) *Cross references.* For rules relating to premiums paid by an employer for an annuity contract which is not subject to section 403(a), see section 403(c) and the regulations thereunder. For rules relating to contributions made to an employees' trust which is not exempt under section 501(a), see section 402(b) and the regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6696, 28 FR 13450, Dec. 12, 1963; T.D. 6856, 30 FR 13316, Oct. 20, 1965; T.D. 6888, 31 FR 9200, July 6, 1966; T.D. 7544, 43 FR 31913, July 24, 1978; T.D. 7623, 44 FR 28800, May 17, 1979]

§ 1.61-3 Gross income derived from business.

(a) *In general.* In a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Gross income is determined without subtraction of depletion allowances based on a percentage of income to the extent that it exceeds cost depletion which may be required

to be included in the amount of inventoriable costs as provided in § 1.471–11 and without subtraction of selling expenses, losses or other items not ordinarily used in computing costs of goods sold or amounts which are of a type for which a deduction would be disallowed under section 162(c), (f), or (g) in the case of a business expense. The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer.

(b) *State contracts.* The profit from a contract with a State or political subdivision thereof must be included in gross income. If warrants are issued by a city, town, or other political subdivision of a State, and are accepted by the contractor in payment for public work done, the fair market value of such warrants should be returned as income. If, upon conversion of the warrants into cash, the contractor does not receive and cannot recover the full value of the warrants so returned, he may deduct any loss sustained from his gross income for the year in which the warrants are so converted. If, however, he realizes more than the value of the warrants so returned, he must include the excess in his gross income for the year in which realized.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7207, 37 FR 20767, Oct. 5, 1972; T.D. 7285, 38 FR 26184, Sept. 19, 1973]

§ 1.61–4 Gross income of farmers.

(a) *Farmers using the cash method of accounting.* A farmer using the cash receipts and disbursements method of accounting shall include in his gross income for the taxable year—

(1) The amount of cash and the value of merchandise or other property received during the taxable year from the sale of livestock and produce which he raised,

(2) The profits from the sale of any livestock or other items which were purchased,

(3) All amounts received from breeding fees, fees from rent of teams, machinery, or land, and other incidental farm income,

(4) All subsidy and conservation payments received which must be considered as income, and

(5) Gross income from all other sources.

The profit from the sale of livestock or other items which were purchased is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale of purchased animals held for draft, breeding, or dairy purposes, the profits shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation allowed or allowable (determined in accordance with the rules applicable under section 1016(a) and the regulations thereunder). However, see section 162 and the regulations thereunder with respect to the computation of taxable income on other than the crop method where the cost of seeds or young plants purchased for further development and cultivation prior to sale is involved. Crop shares (whether or not considered rent under State law) shall be included in gross income as of the year in which the crop shares are reduced to money or the equivalent of money.

(b) *Farmers using an accrual method of accounting.* A farmer using an accrual method of accounting must use inventories to determine his gross income. His gross income on an accrual method is determined by adding the total of the items described in subparagraphs (1) through (5) of this paragraph and subtracting therefrom the total of the items described in subparagraphs (6) and (7) of this paragraph. These items are as follows:

(1) The sales price of all livestock and other products held for sale and sold during the year;

(2) The inventory value of livestock and products on hand and not sold at the end of the year;

(3) All miscellaneous items of income, such as breeding fees, fees from the rent of teams, machinery, or land, or other incidental farm income;

(4) Any subsidy or conservation payments which must be considered as income;

(5) Gross income from all other sources;

(6) The inventory value of the livestock and products on hand and not sold at the beginning of the year; and

(7) The cost of any livestock or products purchased during the year (except livestock held for draft, dairy, or breeding purposes, unless included in inventory).

All livestock raised or purchased for sale shall be added in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Livestock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory (see subparagraphs (2), (6), and (7) of this paragraph) instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer. When any livestock included in an inventory are sold, their cost must not be taken as an additional deduction in computing taxable income, because such deduction is reflected in the inventory. See the regulations under section 471. Crop shares (whether or not considered rent under State law) shall be included in gross income as of the year in which the crop shares are reduced to money or the equivalent of money.

(c) *Special rules for certain receipts.* In the case of the sale of machinery, farm equipment, or any other property (except stock in trade of the taxpayer, or property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business), any excess of the proceeds of the sale over the adjusted basis of such property shall be included in the taxpayer's gross income for the taxable year in which such sale is made. See, however, section 453 and the regulations thereunder for special rules relating to certain installment sales. If farm produce is exchanged for merchandise, groceries, or the like, the market value of the article received in exchange is to be included in gross income. Proceeds of insurance, such as hail or fire insurance on growing crops, should be included in gross income to the extent of the amount received in cash or its equivalent for the crop injured or destroyed. See section 451(d) for special rule relating to election to include crop insurance proceeds in income for taxable year following taxable year of destruction. For taxable years beginning after July 12, 1972, where a farmer is engaged in producing crops and the process of gathering and disposing of such crops is not completed within the taxable year in which such crops are planted, the income therefrom may, with the consent of the Commissioner (see section 446 and the regulations thereunder), be computed upon the crop method. For taxable years beginning on or before July 12, 1972, where a farmer is engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing, the income therefrom may, with the consent of the Commissioner (see section 446 and the regulations thereunder), be computed upon the crop method. In any case in which the crop method is used, the entire cost of producing the crop must be taken as a deduction for the year in which the gross income from the crop is realized, and not earlier.

(d) *Definition of "farm".* As used in this section, the term "farm" embraces the farm in the ordinarily accepted sense, and includes stock, dairy, poultry, fruit, and truck farms; also plantations, ranches, and all land used for farming operations. All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated as farmers. For more detailed rules with respect to the determination of whether or not an individual is engaged in farming, see § 1.175-3. For rules applicable to persons cultivating or operating a farm for recreation or pleasure, see sections 162 and 165, and the regulations thereunder.

(e) *Cross references.* (1) For election to include Commodity Credit Corporation loans as income, see section 77 and regulations thereunder.

(2) For definition of gross income derived from farming for purposes of

limiting deductibility of soil and water conservation expenditures, see section 175 and regulations thereunder.

(3) For definition of gross income from farming in connection with declarations of estimated income tax, see section 6073 and regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7198, 37 FR 13679, July 13, 1972]

§ 1.61-5 Allocations by cooperative associations; per-unit retain certificates—tax treatment as to cooperatives and patrons.

(a) *In general.* Amounts allocated on the basis of the business done with or for a patron by a cooperative association, whether or not entitled to tax treatment under section 522, in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice or in some other manner disclosing to the patron the dollar amount allocated, shall be included in the computation of the gross income of such patron for the taxable year in which received to the extent prescribed in paragraph (b) of this section, regardless of whether the allocation is deemed, for the purpose of section 522, to be made at the close of a preceding taxable year of the cooperative association. The determination of the extent of taxability of such amounts is in no way dependent upon the method of accounting employed by the patron or upon the method, cash, accrual, or otherwise, upon which the taxable income of such patron is computed.

(b) *Extent of taxability.* (1) Amounts allocated to a patron on a patronage basis by a cooperative association with respect to products marketed for such patron, or with respect to supplies, equipment, or services, the cost of which was deductible by the patron under section 162 or section 212, shall be included in the computation of the gross income of such patron, as ordinary income, to the following extent:

(i) If the allocation is in cash, the amount of cash received.

(ii) If the allocation is in merchandise, the amount of the fair market value of such merchandise at the time of receipt by the patron.

(iii) If the allocation is in the form of revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or similar documents, the amount of the fair market value of such document at the time of its receipt by the patron. For purposes of this subdivision, any document containing an unconditional promise to pay a fixed sum of money on demand or at a fixed or determinable time shall be considered to have a fair market value at the time of its receipt by the patron, unless it is clearly established to the contrary. However, for purposes of this subdivision, any document which is payable only in the discretion of the cooperative association, or which is otherwise subject to conditions beyond the control of the patron, shall be considered not to have any fair market value at the time of its receipt by the patron, unless it is clearly established to the contrary.

(iv) If the allocation is in the form of capital stock, the amount of the fair market value, if any, of such capital stock at the time of its receipt by the patron.

(2) If any allocation to which subparagraph (1) of this paragraph applies is received in the form of a document of the type described in subparagraph (1) (iii) or (iv) of this paragraph and is redeemed in full or in part or is otherwise disposed of, there shall be included in the computation of the gross income of the patron, as ordinary income, in the year of redemption or other disposition, the excess of the amount realized on the redemption or other disposition over the amount previously included in the computation of gross income under such subparagraph.

(3) (i) Amounts which are allocated on a patronage basis by a cooperative association with respect to supplies, equipment, or services, the cost of which was not deductible by the patron under section 162 or section 212, are not includible in the computation of the gross income of such patron. However, in the case of such amounts which are allocated with respect to capital assets (as defined in section 1221) or property used in the

trade or business within the meaning of section 1231, such amounts shall, to the extent set forth in subparagraph (1) of this paragraph, be taken into account by such patron in determining the cost of the property to which the allocation relates. Notwithstanding the preceding sentence, to the extent that such amounts are in excess of the unrecovered cost of such property, and to the extent that such amounts relate to such property which the patron no longer owns, they shall be included in the computation of the gross income of such patron.

(ii) If any patronage dividend is allocated to the patron in the form of a document of the type described in subparagraph (1) (iii) or (iv) of this paragraph, and if such allocation is with respect to capital assets (as defined in section 1221) or property used in the trade or business within the meaning of section 1231, any amount realized on the redemption or other disposition of such document which is in excess of the amount which was taken into account upon the receipt of the document by the patron shall be taken into account by such patron in the year of redemption or other disposition as an adjustment to basis or as an inclusion in the computation of gross income, as the case may be.

(iii) Any adjustment to basis in respect of an amount to which subdivision (i) or (ii) of this subparagraph applies shall be made as of the first day of the taxable year in which such amount is received.

(iv) The application of the provisions of this subparagraph may be illustrated by the following examples:

Example (1). On July 1, 1959, P, a patron of a cooperative association, purchases a tractor for use in his farming business from such association for $2,200. The tractor has an estimated useful life of five years and an estimated salvage value of $200. P files his income tax returns on a calendar year basis and claims depreciation on the tractor for the year 1959 of $200 pursuant to his use of the straight-line method at the rate of $400 per year. On July 1, 1960, the cooperative association allocates to P with respect to his purchase of the tractor a dividend of $300 in cash. P will reduce his depreciation allowance with respect to the tractor for 1960 (and subsequent taxable years) to $333.33, determined as follows:

Cost of tractor, July 1, 1959		$2,200
Less:		
Depreciation for 1959 (6 mos.)	$200	
Adjustment as of Jan. 1, 1960, for cash patronage dividend	300	
Salvage value	200	
		700
Basis for depreciation for the remaining 4½ years of estimated life		1,500
Basis for depreciation divided by the 4½ years of remaining life		333.33

Example (2). Assume the same facts as in example (1), except that on July 1, 1960, the cooperative association allocates a dividend to P with respect to his purchase of the tractor in the form of a revolving fund certificate having a face amount of $300. The certificate is redeemable in cash at the discretion of the directors of the association and is subject to diminution by any future losses of the association, and has no fair market value when received by P. Since the certificate had no fair market value when received by P, no amount with respect to such certificate was taken into account by him in the year 1960. In 1965, P receives $300 cash from the association in full redemption of the certificate. Prior to 1965, he had recovered through depreciation $2,000 of the cost of the tractor, leaving an unrecovered cost of $200 (the salvage value). For the year 1965, the redemption proceeds of $300 are applied against the unrecovered cost of $200, reducing the basis to zero, and the balance of the redemption proceeds, $100, is includible in the computation of P's gross income.

Example (3). Assume the same facts as in example (2), except that the certificate is redeemed in full on July 1, 1962. The full $300 received on redemption of the certificate will be applied against the unrecovered cost of the tractor as of January 1, 1962, computed as follows:

Cost of tractor, July 1, 1959		$2,200
Less:		
Depreciation for 1959 (6 mos.)	$200	
Depreciation for 1960	400	
Depreciation for 1961	400	
		1,000
Unrecovered cost on Jan. 1, 1962		1,200
Adjustment as of Jan. 1, 1962, for proceeds of the redemption of the revolving fund certificate		300
Unrecovered cost on Jan. 1, 1962, after adjustment		900
Less: Salvage value		200
Basis for depreciation on Jan. 1, 1962		700
If P uses the tractor in his business until June 30, 1964, he would be entitled to the following depreciation allowances with respect to the tractor:		
For 1962	280	
For 1963	280	
For 1964 (6 mos.)	140	
		700
Balance to be depreciated		0

Example (4). Assume the same facts as in example (3), except that P sells the tractor in 1961. The entire $300 received in 1962 in redemption of the revolving fund certificate is includible in the computation of P's gross income for the year 1962.

(c) *Special rule.* If, for any taxable year ending before December 3, 1959, a taxpayer treated any patronage dividend received in the form of a document described in paragraph (b) (1) (iii) or (iv) of this section in accordance with the regulations then applicable (whether such dividend is subject to paragraph (b) (1) or (3) of this section), such taxpayer is not required to change the treatment of such patronage dividends for any such prior taxable year. On the other hand, the taxpayer may, if he so desires, amend his income tax returns to treat the receipt of such patronage dividend in accordance with the provisions of this section, but no provision in this paragraph shall be construed as extending the period of limitations within which a claim for credit or refund may be filed under section 6511.

(d) *Per-unit retain certificates; tax treatment of cooperative associations; distribution and reinvestment alternative.* (1) (i) In the case of a taxable year to which this paragraph applies to a cooperative association, such association shall, in computing the amount paid or returned to a patron with respect to products marketed for such patron, take into account the stated dollar amount of any per-unit retain certificate (as defined in paragraph (g) of this section)—

(*a*) Which is issued during the payment period for such year (as defined in subparagraph (3) of this paragraph) with respect to such products,

(*b*) With respect to which the patron is a qualifying patron (as defined in subparagraph (2) of this paragraph), and

(*c*) Which clearly states the fact that the patron has agreed to treat the stated dollar amount thereof as representing a cash distribution to him which he has reinvested in the cooperative association.

(ii) No amount shall be taken into account by a cooperative association by reason of the issuance of a per-unit retain certificate to a patron who was not a qualifying patron with respect to such certificate. However, any amount paid in redemption of a per-unit retain certificate which was issued to a patron who was not a qualifying patron with respect to such certificate shall be taken into account by the cooperative in the year of redemption, as an amount paid or returned to such patron with respect to products marketed for him. This subdivision shall apply only to per-unit retain certificates issued with respect to taxable years of the cooperative association to which this paragraph applied to the association (that is, taxable years with respect to which per-unit retain certificates were issued to one or more patrons who are qualifying patrons).

(2) (i) A patron shall be considered to be a "qualifying patron" with respect to a per-unit retain certificate if there is in effect an agreement between the cooperative association and such patron which clearly provides that such patron agrees to treat the stated dollar amounts of all per-unit retain certificates issued to him by the association as representing cash distributions which he has constructively received and which he has, of his own choice, reinvested in the cooperative association. Such an agreement may be included in a by-law of the cooperative which is adopted prior to the time the products to which the per-unit retain certificates relate are marketed. However, except where there is in effect a "written agreement" described in subdivision (ii) of this subparagraph, a patron shall not be considered to be a "qualifying patron" with respect to a per-unit retain certificate if it has been established by a determination of the Tax Court of the United States, or any other court of competent jurisdiction, which has become final, that the stated dollar amount of such certificate, or of a similar certificate issued under similar circumstances to such patron or any other patron by the cooperative association, is not required to be included (as ordinary income) in the gross income of such patron, or such other patron, for the taxable year of the patron in which received.

(ii) The "written agreement" referred to in subdivision (i) of this subparagraph is an agreement in writing, signed by the patron, on file with the cooperative association, and revocable as provided in this subdivision. Unless such an agreement specifically provides to the contrary, it shall be effective for per-unit retain certificates issued with respect to the taxable year of the cooperative association in which the agreement is received by the association, and unless revoked, for per-unit retain certificates issued with respect to all subsequent taxable years. A "written agreement" must be revocable by the patron at any time after the close of the taxable year in which it is made. To be effective, a revocation must be in writing, signed by the patron, and furnished to the cooperative association. A revocation shall be effective only for per-unit retain certificates issued with respect to taxable years of the cooperative association following the taxable year in which it is furnished to the association. Notwithstanding the preceding sentence, a revocation shall not be effective for per-unit retain certificates issued with respect to products marketed for the patron under a pooling arrangement in which such patron participated before such revocation. The following is an example of an agreement which would meet the requirements of this subparagraph:

I agree that, for purposes of determining the amount I have received from this cooperative in payment for my goods, I shall treat the face amount of any per-unit retain certificates issued to me on and after ——— as representing a cash distribution which I have constructively received and which I have reinvested in the cooperative.

———————————————

———————————————

(Signed)

(3) For purposes of this paragraph and paragraph (e) of this section, the payment period for any taxable year of the cooperative is the period beginning with the first day of such taxable year and ending with the 15th day of the 9th month following the close of such year.

(4) This paragraph shall apply to any taxable year of a cooperative association if, with respect to such taxable year, the association has issued per-unit retain certificates to one or more of its patrons who are qualifying patrons with respect to such certificates within the meaning of subparagraph (2) of this paragraph.

(e) *Tax treatment of cooperative association; taxable years for which paragraph (d) does not apply.* (1) In the case of a taxable year to which paragraph (d) of this section does not apply to a cooperative association, such association shall, in computing the amount paid or returned to a patron with respect to products marketed for such patron, take into account the fair market value (at the time of issue) of any per-unit retain certificates which are issued by the association with respect to such products during the payment period for such taxable year.

(2) An amount paid in redemption of a per-unit retain certificate issued with respect to a taxable year of the cooperative association for which paragraph (d) of this section did not apply to the association, shall, to the extent such amount exceeds the fair market value of the certificate at the time of its issue, be taken into account by the association in the year of redemption, as an amount paid or returned to a patron with respect to products marketed for such patron.

(3) For purposes of this paragraph and paragraph (f)(2) of this section, any per-unit retain certificate containing an unconditional promise to pay a fixed sum of money on demand or at a fixed or determinable time shall be considered to have a fair market value at the time of its issue, unless it is clearly established to the contrary. On the other hand, any per-unit retain certificate (other than capital stock) which is redeemable only in the discretion of the cooperative association, or which is otherwise subject to conditions beyond the control of the patron, shall be considered not to have any fair market value at the time of its issue, unless it is clearly established to the contrary.

(f) *Tax treatment of patron.* (1) The following rules apply for purposes of

computing the amount includible in gross income with respect to a per-unit retain certificate which was issued to a patron by a cooperative association with respect to a taxable year of such association for which paragraph (d) of this section applies.

(i) If the patron is a qualifying patron with respect to such certificate (within the meaning of paragraph (d)(2) of this section), he shall, in accordance with his agreement, include (as ordinary income) the stated dollar amount of the certificate in gross income for his taxable year in which the certificate is received by him.

(ii) If the patron is not a qualifying patron with respect to such certificate, no amount is includible in gross income on the receipt of the certificate; however, any gain on the redemption, sale, or other disposition of such certificate shall, to the extent of the stated dollar amount thereof, be considered as gain from the sale or exchange of property which is not a capital asset.

(2) The amount of the fair market value of a per-unit retain certificate which is issued to a patron by a cooperative association with respect to a taxable year of the association for which paragraph (d) of this section does not apply shall be included, as ordinary income, in the gross income of the patron for the taxable year in which the certificate is received. Any gain on the redemption, sale, or other disposition of such a per-unit retain certificate shall, to the extent its stated dollar amount exceeds its fair market value at the time of issue, be treated as gain on the redemption, sale, or other disposition of property which is not a capital asset.

(g) *"Per-unit retain certificate" defined.* For purposes of paragraphs (d), (e), and (f), of this section, the term "per-unit retain certificate" means any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice—

(1) Which is issued to a patron with respect to products marketed for such patron;

(2) Which discloses to the patron the stated dollar amount allocated to him on the books of the cooperative association; and

(3) The stated dollar amount of which is fixed without reference to net earnings.

(h) *Effective date.* This section shall not apply to any amount the tax treatment of which is prescribed in section 1385 and § 1.1385-1. Paragraphs (d), (e), and (f) of this section shall apply to per-unit retain certificates as defined in paragraph (g) of this section issued by a cooperative association during taxable years of the association beginning after April 30, 1966, with respect to products marketed for patrons during such years.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6855, 30 FR 13134, Oct. 15, 1965]

§ 1.61-6 Gains derived from dealings in property.

(a) *In general.* Gain realized on the sale or exchange of property is included in gross income, unless excluded by law. For this purpose property includes tangible items, such as a building, and intangible items, such as goodwill. Generally, the gain is the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged. The specific rules for computing the amount of gain or loss are contained in section 1001 and the regulations thereunder. When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of. This rule may be illustrated by the following examples:

Example (1). A, a dealer in real estate, acquires a 10-acre tract for $10,000, which he divides into 20 lots. The $10,000 cost must be equitably apportioned among the lots so

that on the sale of each A can determine his taxable gain or deductible loss.

Example (2). B purchases for $25,000 property consisting of a used car lot and adjoining filling station. At the time, the fair market value of the filling station is $15,000 and the fair market value of the used car lot is $10,000. Five years later B sells the filling station for $20,000 at a time when $2,000 has been properly allowed as depreciation thereon. B's gain on this sale is $7,000, since $7,000 is the amount by which the selling price of the filling station exceeds the portion of the cost equitably allocable to the filling station at the time of purchase reduced by the depreciation properly allowed.

(b) *Nontaxable exchanges.* Certain realized gains or losses on the sale or exchange of property are not "recognized", that is, are not included in or deducted from gross income at the time the transaction occurs. Gain or loss from such sales or exchanges is generally recognized at some later time. Examples of such sales or exchanges are the following:

(1) Certain formations, reorganizations, and liquidations of corporations, see sections 331, 333, 337, 351, 354, 355, and 361;

(2) Certain formations and distributions of partnerships, see sections 721 and 731;

(3) Exchange of certain property held for productive use or investment for property of like kind, see section 1031;

(4) A corporation's exchange of its stock for property, see section 1032;

(5) Certain involuntary conversions of property if replaced, see section 1033;

(6) Sale or exchange of residence if replaced, see section 1034;

(7) Certain exchanges of insurance policies and annuity contracts, see section 1035; and

(8) Certain exchanges of stock for stock in the same corporation, see section 1036.

(c) *Character of recognized gain.* Under subchapter P, chapter 1 of the Code, relating to capital gains and losses, certain gains derived from dealings in property are treated specially, and under certain circumstances the maximum rate of tax on such gains is 25 percent, as provided in section 1201. Generally, the property subject to this treatment is a "capital asset", or treated as a "capital asset". For definition of such assets, see sections 1221 and 1231, and the regulations thereunder. For some of the rules either granting or denying this special treatment, see the following sections and the regulations thereunder:

(1) Transactions between partner and partnership, section 707;

(2) Sale or exchange of property used in the trade or business and involuntary conversions, section 1231;

(3) Payment of bonds and other evidences of indebtedness, section 1232;

(4) Gains and losses from short sales, section 1233;

(5) Options to buy or sell, section 1234;

(6) Sale or exchange of patents, section 1235;

(7) Securities sold by dealers in securities, section 1236;

(8) Real property subdivided for sale, section 1237;

(9) Amortization in excess of depreciation, section 1238;

(10) Gain from sale of certain property between spouses or between an individual and a controlled corporation, section 1239;

(11) Taxability to employee of termination payments, section 1240.

§ 1.61-7 Interest.

(a) *In general.* As a general rule, interest received by or credited to the taxpayer constitutes gross income and is fully taxable. Interest income includes interest on savings or other bank deposits; interest on coupon bonds; interest on an open account, a promissory note, a mortgage, or a corporate bond or debenture; the interest portion of a condemnation award; usurious interest (unless by State law it is automatically converted to a payment on the principal); interest on legacies; interest on life insurance proceeds held under an agreement to pay interest thereon; and interest on refunds of Federal taxes. For rules determining the taxable year in which interest, including interest accrued or constructively received, is included in gross income, see section 451 and the regulations thereunder. For the inclusion of interest in income for the purpose of the retirement income credit, see section 37 and the regulations thereun-

der. For credit of tax withheld at source on interest on tax-free covenant bonds, see section 32 and the regulations thereunder. For rules relating to interest on certain deferred payments, see section 483 and the regulations thereunder.

(b) *Interest on Government obligations*—(1) *Wholly tax-exempt interest.* Interest upon the obligations of a State, Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia, is wholly exempt from tax. Interest on certain United States obligations issued before March 1, 1941, is exempt from tax to the extent provided in the acts of Congress authorizing the various issues. See section 103 and the regulations thereunder.

(2) *Partially tax-exempt interest.* Interest earned on certain United States obligations is partly tax exempt and partly taxable. For example, the interest on United States Treasury bonds issued before March 1, 1941, to the extent that the principal of such bonds exceeds $5,000, is exempt from normal tax but is subject to surtax. See sections 35 and 103, and the regulations thereunder.

(3) *Fully taxable interest.* In general, interest on United States obligations issued on or after March 1, 1941, and obligations issued by any agency or instrumentality of the United States after that date, is fully taxable; but see section 103 and the regulations thereunder. A taxpayer using the cash receipts and disbursements method of accounting who owns United States savings bonds issued at a discount has an election as to when he will report the interest; see section 454 and the regulations thereunder.

(c) *Obligations bought at a discount; bonds bought when interest defaulted or accrued.* When notes, bonds, or other certificates of indebtedness are issued by a corporation or the Government at a discount and are later redeemed by the debtor at the face amount, the original discount is interest, except as otherwise provided by law. See also paragraph (b) of this section for the rules relating to Government bonds. If a taxpayer purchases bonds when interest has been defaulted or when the interest has accrued but has not been paid, any interest which is in arrears but has accrued at the time of purchase is not income and is not taxable as interest if subsequently paid. Such payments are returns of capital which reduce the remaining cost basis. Interest which accrues after the date of purchase, however, is taxable interest income for the year in which received or accrued (depending on the method of accounting used by the taxpayer).

(d) *Bonds sold between interest dates; amounts received in excess of original issue discount; interest on life insurance.* When bonds are sold between interest dates, part of the sales price represents interest accrued to the date of the sale and must be reported as interest income. Amounts received in excess of the original issue discount upon the retirement or sale of a bond or other evidence of indebtedness may under some circumstances constitute capital gain instead of ordinary income. See section 1232 and the regulations thereunder. Interest payments on amounts payable as employees' death benefits (whether or not section 101(b) applies thereto) and on the proceeds of life insurance policies payable by reason of the insured's death constitute gross income under some circumstances. See section 101 and the regulations thereunder for details. Where accrued interest on unwithdrawn insurance policy dividends is credited annually and is subject to withdrawal annually by the taxpayer, such interest credits constitute gross income to such taxpayer as of the year of credit. However, if under the terms of the insurance policy the interest on unwithdrawn policy dividends is subject to withdrawal only on the anniversary date of the policy (or some other date specified therein), then such interest shall constitute gross income to the taxpayer for the taxable year in which such anniversary date (or other specified date) falls.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6723, 29 FR 5342, Apr. 21, 1964; T.D. 6873, 31 FR 941, Jan. 25, 1966]

§ 1.61-8 Rents and royalties.

(a) *In general.* Gross income includes rentals received or accrued for the occupancy of real estate or the use of personal property. For the inclusion of rents in income for the purpose of the retirement income credit, see section 37 and the regulations thereunder. Gross income includes royalties. Royalties may be received from books, stories, plays, copyrights, trademarks, formulas, patents, and from the exploitation of natural resources, such as coal, gas, oil, copper, or timber. Payments received as a result of the transfer of patent rights may under some circumstances constitute capital gain instead of ordinary income. See section 1235 and the regulations thereunder. For special rules for certain income from natural resources, see subchapter I (section 611 and following), chapter 1 of the Code, and the regulations thereunder.

(b) *Advance rentals; cancellation payments.* Gross income includes advance rentals, which must be included in income for the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer. An amount received by a lessor from a lessee for cancelling a lease constitutes gross income for the year in which it is received, since it is essentially a substitute for rental payments. As to amounts received by a lessee for the cancellation of a lease, see section 1241 and the regulations thereunder.

(c) *Expenditures by lessee.* As a general rule, if a lessee pays any of the expenses of his lessor such payments are additional rental income of the lessor. If a lessee places improvements on real estate which constitute, in whole or in part, a substitute for rent, such improvements constitute rental income to the lessor. Whether or not improvements made by a lessee result in rental income to the lessor in a particular case depends upon the intention of the parties, which may be indicated either by the terms of the lease or by the surrounding circumstances. For the exclusion from gross income of income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by a lessee, see section 109 and the regulations thereunder. For the exclusion from gross income of a lessor corporation of certain of its income taxes on rental income paid by a lessee corporation under a lease entered into before January 1, 1954, see section 110 and the regulations thereunder.

§ 1.61-9 Dividends.

(a) *In general.* Except as otherwise specifically provided, dividends are included in gross income under sections 61 and 301. For the principal rules with respect to dividends includible in gross income, see section 316 and the regulations thereunder. As to distributions made or deemed to be made by regulated investment companies, see sections 851 through 855, and the regulations thereunder. As to distributions made by real estate investment trusts, see sections 856 through 858, and the regulations thereunder. See section 116 for the exclusion from gross income of $100 ($50 for dividends received in taxable years beginning before January 1, 1964) of dividends received by an individual, except those from certain corporations. Furthermore, dividends may give rise to a credit against tax under section 34, relating to dividends received by individuals (for dividends received on or before December 31, 1964), and under section 37, relating to retirement income.

(b) *Dividends in kind; stock dividends; stock redemptions.* Gross income includes dividends in property other than cash, as well as cash dividends. For amounts to be included in gross income when distributions of property are made, see section 301 and the regulations thereunder. A distribution of stock, or rights to acquire stock, in the corporation making the distribution is not a dividend except under the circumstances described in section 305(b). However, the term "dividend" includes a distribution of stock, or rights to acquire stock, in a corporation other than the corporation making the distribution. For determining when distributions in complete liquidation shall be treated as dividends, see section 333 and the reg-

ulations thereunder. For rules determining when amounts received in exchanges under section 354 or exchanges and distributions under section 355 shall be treated as dividends, see section 356 and the regulations thereunder.

(c) *Dividends on stock sold.* When stock is sold, and a dividend is both declared and paid after the sale, such dividend is not gross income to the seller. When stock is sold after the declaration of a dividend and after the date as of which the seller becomes entitled to the dividend, the dividend ordinarily is income to the seller. When stock is sold between the time of declaration and the time of payment of the dividend, and the sale takes place at such time that the purchaser becomes entitled to the dividend, the dividend ordinarily is income to him. The fact that the purchaser may have included the amount of the dividend in his purchase price in contemplation of receiving the dividend does not exempt him from tax. Nor can the purchaser deduct the added amount he advanced to the seller in anticipation of the dividend. That added amount is merely part of the purchase price of the stock. In some cases, however, the purchaser may be considered to be the recipient of the dividend even though he has not received the legal title to the stock itself and does not himself receive the dividend. For example, if the seller retains the legal title to the stock as trustee solely for the purpose of securing the payment of the purchase price, with the understanding that he is to apply the dividends received from time to time in reduction of the purchase price, the dividends are considered to be income to the purchaser.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6777, 29 FR 17807, Dec. 16, 1964]

§ 1.61-10 Alimony and separate maintenance payments; annuities; income from life insurance and endowment contracts.

(a) *In general.* Alimony and separate maintenance payments, annuities, and income from life insurance and endowment contracts in general constitute gross income, unless excluded by law. Annuities paid by religious, charitable, and educational corporations are generally taxable to the same extent as other annuities. An annuity charged upon devised land is taxable to the donee-annuitant to the extent that it becomes payable out of the rents or other income of the land, whether or not it is a charge upon the income of the land.

(b) *Cross references.* For the detailed rules relating to—

(1) Alimony and separate maintenance payments, see section 71 and the regulations thereunder;

(2) Annuities, certain proceeds of endowment and life insurance contracts, see section 72 and the regulations thereunder;

(3) Life insurance proceeds paid by reason of death of insured, employees' death benefits, see section 101 and the regulations thereunder;

(4) Annuities paid by employees' trusts, see section 402 and the regulations thereunder;

(5) Annuities purchased for employee by employer, see section 403 and the regulations thereunder.

§ 1.61-11 Pensions.

(a) *In general.* Pensions and retirement allowances paid either by the Government or by private persons constitute gross income unless excluded by law. Usually, where the taxpayer did not contribute to the cost of a pension and was not taxable on his employer's contributions, the full amount of the pension is to be included in his gross income. But see sections 72, 402, and 403, and the regulations thereunder. When amounts are received from other types of pensions, a portion of the payment may be excluded from gross income. Under some circumstances, amounts distributed from a pension plan in excess of the employee's contributions may constitute long-term capital gain, rather than ordinary income.

(b) *Cross references.* For the inclusion of pensions in income for the purpose of the retirement income credit, see section 37 and the regulations thereunder. Detailed rules concerning the extent to which pensions and retirement allowances are to be included

in or excluded from gross income are contained in other sections of the Code and the regulations thereunder. Amounts received as pensions or annuities under the Social Security Act (42 U.S.C. ch. 7) or the Railroad Retirement Act (45 U.S.C. ch. 9) are excluded from gross income. For other partial and total exclusions from gross income, see the following:

(1) Annuities in general, section 72 and the regulations thereunder;

(2) Employees' annuities, sections 402 and 403 and the regulations thereunder;

(3) References to other acts of Congress exempting veterans' pensions and railroad retirement annuities and pensions, section 122.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6856, 30 FR 13316, Oct. 20, 1965]

§ 1.61-12 Income from discharge of indebtedness.

(a) *In general.* The discharge of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, the debtor realizes income in the amount of the debt as compensation for his services. A taxpayer may realize income by the payment or purchase of his obligations at less than their face value. In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.

(b) *Proceedings under Bankruptcy Act.* (1) Income is not realized by a taxpayer by virtue of the discharge, under section 14 of the Bankruptcy Act (11 U.S.C. 32), of his indebtedness as the result of an adjudication in bankruptcy, or by virtue of an agreement among his creditors not consummated under any provision of the Bankruptcy Act, if immediately thereafter the taxpayer's liabilities exceed the value of his assets. Furthermore, unless one of the principal purposes of seeking a confirmation under the Bankruptcy Act is the avoidance of income tax, income is not realized by a taxpayer in the case of a cancellation or reduction of his indebtedness under—

(i) A plan of corporate reorganization confirmed under Chapter X of the Bankruptcy Act (11 U.S.C., ch. 10);

(ii) An "arrangement" or a "real property arrangement" confirmed under Chapter XI or XII, respectively, of the Bankruptcy Act (11 U.S.C., ch. 11, 12); or

(iii) A "wage earner's plan" confirmed under Chapter XIII of the Bankruptcy Act (11 U.S.C., ch. 13).

(2) For adjustment of basis of certain property in the case of cancellation or reduction of indebtedness resulting from a proceeding under the Bankruptcy Act, see the regulations under section 1016.

(c) *Issuance and repurchase of corporate bonds.* (1) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss.

(2) If, subsequent to February 28, 1913, bonds are issued by a corporation at a premium (as defined in subparagraph (4) of this paragraph), the net amount of such premium, excluding any portion thereof which is attributable to a conversion feature of the bond under paragraph (c) of § 1.171-2, is income which should be prorated or amortized over the life of the bonds. If bonds were issued by a corporation prior to March 1, 1913, at a premium, the net amount of such premium was income for the year in which the bonds were issued and should not be prorated or amortized over the life of the bonds.

(3) If bonds are issued by a corporation and are subsequently repurchased by the corporation at a price which is exceeded by the issue price plus any amount of discount already deducted, or (in the case of bonds issued subsequent to Feb. 28, 1913) minus any amount of premium already returned as income, the amount of such excess is income for the taxable year.

(4) For purposes of this paragraph, bond premium equals the excess of the issue price of the bond (as defined in paragraph (b)(2) of § 1.1232-3) over the amount payable at maturity (or in the case of a callable bond, at the earlier call date).

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(5) The provisions of this paragraph are illustrated by the following examples:

Example. (i) M Corporation, on January 1, 1946, the beginning of its taxable year, issued for $115,000, 3 percent bonds, maturing 10 years from the date of issue, with a stated redemption price at maturity of $100,000. The bonds were convertible into common stock at the option of the holder. The value of the conversion feature of the bonds, as determined under paragraph (c) of § 1.171-2, is $11,500. The net amount, or amortizable portion, of bond premium which is included in income over the 10-year life of the bonds is $3,500, computed as follows:

Issue price	$115,000
Less: Redemption price	100,000
Premium	15,000
Value of conversion feature	11,500
Amortizable amount	3,500

(ii) On January 1, 1950, M Corporation repurchased all of the bonds for a total price of $110,000. M Corporation thereby realized income for the taxable year 1950 in the amount of $3,600, computed as follows:

Issue price	$115,000
Less: Portion of original premium previously amortized, 1946-1949 (4/10 × $3,500)	1,400
	113,600
Repurchase price	110,000
Income	3,600

(6) For purposes of this paragraph, a debenture, note, or certificate or other evidence of indebtedness, issued by a corporation and bearing interest shall be given the same treatment as a bond.

(7) For rules relating to amortization of bond discount and the deduction upon repurchase of bonds at an amount in excess of their issue price, see § 1.163-3.

(d) *Cross references.* For exclusion from gross income of—

(1) Income from discharge of indebtedness in certain cases, see sections 108 and 1017, and regulations thereunder;

(2) Forgiveness of Government payments to encourage exploration, development, and mining for defense purposes, see section 621 and regulations thereunder.

(e) *Cross reference.* For rules relating to the treatment of liabilities on the sale or other disposition of encumbered property, see § 1.1001-2.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6984, 33 FR 19174, Dec. 24, 1968; T.D. 7741, 45 FR 81745, Dec. 12, 1980]

§ 1.61-13 Distributive share of partnership gross income; income in respect of a decedent; income from an interest in an estate or trust.

(a) *In general.* A partner's distributive share of partnership gross income (under section 702(c)) constitutes gross income to him. Income in respect of a decedent (under section 691) constitutes gross income to the recipient. Income from an interest in an estate or trust constitutes gross income under the detailed rules of part I (section 641 and following), subchapter J, chapter 1 of the Code. In many cases, these sections also determine who is to include in his gross income the income from an estate or trust.

(b) *Creation of sinking fund by corporation.* If a corporation, for the sole purpose of securing the payment of its bonds or other indebtedness, places property in trust or sets aside certain amounts in a sinking fund under the control of a trustee who may be authorized to invest and reinvest such sums from time to time, the property or fund thus set aside by the corporation and held by the trustee is an asset of the corporation, and any gain arising therefrom is income of the corporation and shall be included as such in its gross income.

§ 1.61-14 Miscellaneous items of gross income.

(a) *In general.* In addition to the items enumerated in section 61(a), there are many other kinds of gross income. For example, punitive damages such as treble damages under the antitrust laws and exemplary damages for fraud are gross income. Another person's payment of the taxpayer's income taxes constitutes gross income to the taxpayer unless excluded by law. Illegal gains constitute gross income. Treasure trove, to the extent of its value in United States currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession.

(b) *Cross references.* (1) Prizes and awards, see section 74 and regulations thereunder;

(2) Damages for personal injury or sickness, see section 104 and the regulations thereunder;

(3) Income taxes paid by lessee corporation, see section 110 and regulations thereunder;

(4) Scholarships and fellowship grants, see section 117 and regulations thereunder;

(5) Miscellaneous exemptions under other acts of Congress, see section 122;

(6) Tax-free covenant bonds, see section 1451 and regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6856, 30 FR 13316, Oct. 20, 1965]

§ 1.61-15 Options received as payment of income

(a) *In general.* Except as otherwise provided in § 1.61-2(d)(6)(i) (relating to certain restricted property transferred after June 30, 1969), if any person receives an option in payment of an amount constituting compensation of such person (or any other person), such option is subject to the rules contained in § 1.421-6 for purposes of determining when income is realized in connection with such option and the amount of such income. In this regard, the rules of § 1.421-6 apply to an option received in payment of an amount constituting compensation regardless of the form of the transaction. Thus, the rules of § 1.421-6 apply to an option transferred for less than its fair market value in a transaction taking the form of a sale or exchange if the difference between the amount paid for the option and its fair market value at the time of transfer is the payment of an amount constituting compensation of the transferee or any other person. This section, for example, makes the rules of § 1.421-6 applicable to options granted in whole or partial payment for services of an independent contractor. If an amount of money or property is paid for an option to which this paragraph applies, then the amount paid shall be part of the basis of such option.

(b) *Options to which paragraph (a) does not apply.* (1) Paragraph (a) of this section does not apply to:

(i) An option which is subject to the rules contained in section 421; and

(ii) An option which is not granted as the payment of an amount constituting compensation, such as an option which is acquired solely as an investment (including an option which is part of an investment unit described in paragraph (b) of § 1.1232-3). For rules relating to the taxation of options described in this subdivision, see section 1234 and the regulations thereunder.

(2) If a person acquires an option which is not subject to the rules contained in section 421, and if such option has a readily ascertainable fair market value, such person may establish that such option was not acquired as payment of an amount constituting compensation by showing that the amount of money or its equivalent paid for the option equaled the readily ascertainable fair market value of the option. If a person acquires an option which is not subject to the rules contained in section 421, and if such option does not have a readily ascertainable fair market value, then to establish that such option was not acquired as payment of an amount constituting compensation, such person must show that, from an examination of all the surrounding circumstances, there was no reason for the option to have been granted as the payment of an amount constituting compensation. For example, such person must show that he had neither rendered nor was obligated to render substantial services in consideration for the granting of the option. In determining whether an option, such as an option acquired in connection with an obligation as part of an investment unit, has been granted as compensation for services, the ordinary services performed by an investor in his own self-interest in connection with his investing activities will not be treated as the consideration for the grant of the option. For example, if a small business investment company takes an active part in the management of its debtor small business company, the rendering of such management services will not be

treated as the consideration for the granting of the option, provided such services are rendered for an independent consideration, or are merely protective of the small business investment company's investment in the borrower. See paragraph (c) of § 1.421-6 for the meaning of the term "readily ascertainable fair market value."

(c) *Statement required in connection with certain options.* (1) Any person acquiring any option to purchase securities (other than an option described in subparagraph (2) of this paragraph) shall attach a statement to his income tax return for the taxable year in which the option was acquired. For the definition of the term "securities", see section 165(g)(2).

(2) The statement otherwise required by subparagraph (1) of this paragraph shall not be required with respect to the following options:

(i) Options subject to the rules contained in section 305(a) or section 421;

(ii) Options acquired as part of an investment unit consisting of an option and a debenture, note, or other similar obligation—

(*a*) If such unit is acquired as part of a public offering and the amount of money or its equivalent paid for such unit is not less than the public offering price, or

(*b*) If such unit is actively traded on an established market and the amount of money or its equivalent paid for such unit is not less than the price paid for such unit in contemporaneous purchases of such unit by persons independent of both the seller and the taxpayer;

(iii) Options acquired as part of a public offering, if the amount of money or its equivalent paid for such option is not less than the public offering price; and

(iv) Options which are actively traded on an established market and which are acquired for money or its equivalent at a price not less than the price paid for such options in contemporaneous purchases of such options by persons independent of both the seller and the taxpayer.

(3) The statement required by subparagraph (1) of this paragraph shall contain the following information:

(i) Name and address of the taxpayer;

(ii) Description of the securities subject to the option (including number of shares of stock);

(iii) Period during which the option is exercisable;

(iv) Whether the option had a readily ascertainable fair market value at date of grant; and

(v) Whether the option is subject to paragraph (a) of this section.

(4) If the statement required by subparagraph (1) of this paragraph indicates either that the option is not subject to paragraph (a) of this section, or that the option is subject to paragraph (a) of this section but that such option had a readily ascertainable fair market value at date of grant, then such statement shall contain the following additional information:

(i) Option price;

(ii) Value at date of grant of securities subject to the option;

(iii) Restrictions (if any) on exercise or transfer of option;

(iv) Restrictions (if any) on transfer of securities subject to the option;

(v) Value of the option (if readily ascertainable);

(vi) How value of option was determined;

(vii) Amount of money (or its equivalent) paid for the option;

(viii) Person from whom the option was acquired;

(ix) A concise description of the circumstances surrounding the acquisition of the option and any other factors relied upon by the taxpayer to establish that the option is not subject to paragraph (a) of this section, or, if the option is treated by the taxpayer as subject to paragraph (a) of this section, that the option had a readily ascertainable fair market value at date of grant.

(d) *Effective date.* This section shall apply to options granted after July 11, 1963, other than options required to be granted pursuant to the terms of a written contract entered into on or before such date.

[T.D. 6696, 28 FR 13450, Dec. 12, 1963, as amended by T.D. 6706, 29 FR 2911, Mar. 3, 1964; T.D. 6984, 33 FR 19175, Dec. 24, 1968; T.D. 7554, 43 FR 31913, July 24, 1978]

§ 1.62-1 Adjusted gross income.

(a) The term "adjusted gross income" means the gross income computed under section 61 minus such of the deductions allowed by chapter 1 of the Code as are specified in section 62. Adjusted gross income is used as the basis for the determination of the following:

(1) The optional tax if adjusted gross income is less than $5,000 (under section 3);

(2) The amount of the standard deduction (under section 141);

(3) The limitation on the amount of the deduction for charitable contributions (under section 170(b)(1));

(4) The limitation on the amount of the deduction for medical and dental expenses (under section 213); and

(5) In certain cases, the limitation on the deduction for expenses of care of certain dependents (under section 214).

(b) Section 62 merely specifies which of the deductions provided in chapter 1 of the Code shall be allowed in computing adjusted gross income. It does not create any new deductions. The fact that a particular item may be specified in more than one of the paragraphs under section 62 does not permit the item to be twice deducted in computing either adjusted gross income or taxable income.

(c) The deductions specified in section 62 for the purpose of computing adjusted gross income are:

(1) Deductions allowable under chapter 1 of the Code (other than by Part VII (section 211 and following), subchapter B of such chapter) which are attributable to a trade or business carried on by the taxpayer not consisting of services performed as an employee;

(2) Deductions allowable under part VI (section 161 and following), subchapter B, chapter 1 of the Code, which consist of expenses paid or incurred in connection with the performance of services by the taxpayer as an employee under a reimbursement or other expense-allowance arrangement with his employer;

(3) Deductions allowable under part VI which constitute expenses of travel, meals, and lodging while away from home, paid or incurred by the taxpayer in connection with the performance by him of services as an employee;

(4) Transportation expenses (as defined in paragraph (g) of this section) paid or incurred by the taxpayer in connection with the performance by him of services as an employee, allowable as a deduction under part VI;

(5) Deductions allowable by part VI which are attributable to a trade or business carried on by the taxpayer, if such trade or business consists of the performance of services by the taxpayer as an employee and if such trade or business is to solicit, away from the employer's place of business, business for the employer;

(6) The deduction for long-term capital gains allowed by section 1202;

(7) Deductions which are allowable under part VI as losses from the sale or exchange of property;

(8) Deductions allowable under part VI, section 212, and section 611 which are attributable to property held for the production of rents or royalties;

(9) Deductions for depreciation and depletion allowable under sections 167 and 611 to a life tenant of property or to an income beneficiary of property held in trust or to an heir, legatee, or devisee of an estate;

(10) Deductions allowed by sections 404 and 405(c) for contributions on behalf of a self-employed individual;

(11) The deduction for moving expenses allowed by section 217;

(12) The deduction allowed by section 1379(b)(3) to an individual or his beneficiaries upon the termination of rights to receive benefits prior to the excludable recovery of amounts which were included in the gross income of a shareholder-employee as excess employer contributions to a pension, etc., plan of an electing small business corporation;

(13) The deduction allowed by section 219 for contributions to an individual retirement account described in section 408(a), for an individual retirement annuity described in section 408(b), or for a retirement bond described in section 409;

(14) The deduction allowed by section 402(e)(3) for the ordinary income portion of a lump sum distribution;

(15) For taxable years beginning after December 31, 1972, the deduc-

tion allowed by section 165 for losses incurred in any transaction entered into for profit though not connected with a trade or business, to the extent that such losses include amounts forfeited to a bank, mutual savings bank, savings and loan association, building and loan association, cooperative bank or homestead association as a penalty for premature withdrawal of funds from a time savings account, certificate of deposit or similar class of deposit.

(16) For taxable years beginning after December 31, 1976, the deduction for alimony and separate maintenance payments allowed by section 215.

(d) For the purpose of the deductions specified in section 62, the performance of personal services as an employee does not constitute the carrying on of a trade or business, except as otherwise expressly provided. The practice of a profession, not as an employee, is considered the conduct of a trade or business within the meaning of such section. To be deductible for the purposes of determining adjusted gross income, expenses must be those directly, and not those merely remotely, connected with the conduct of a trade or business. For example, taxes are deductible in arriving at adjusted gross income only if they constitute expenditures directly attributable to a trade or business or to property from which rents or royalties are derived. Thus, property taxes paid or incurred on real property used in a trade or business are deductible, but State taxes on net income are not deductible even though the taxpayer's income is derived from the conduct of a trade or business.

(e) Traveling expenses paid or incurred by an employee in connection with his employment while away from home which are deductible from gross income under part VI in computing taxable income may be deducted from gross income in computing adjusted gross income. Among the items included in traveling expenses are charges for transportation of persons or baggage, expenditures for meals and lodging, and payments for the use of sample rooms for the display of goods. See section 162 and the regulations thereunder.

(f) (1) Expenses paid or incurred by an employee which are deductible from gross income under part VI in computing taxable income and for which he is reimbursed by the employer under an express agreement for reimbursement or pursuant to an expense allowance arrangement may be deducted from gross income in computing adjusted gross income. Where an employee is reimbursed by his employer in an amount less than his total expense, and the reimbursement is intended to cover all types of deductible expenses, expenses other than those described in section 62(2) (B), (C), and (D) are taken into account in computing adjusted gross income in an amount which bears the same ratio to the amount of the reimbursement as the total amount of deductible expenses computed without those described in section 62(2) (B), (C), and (D) bears to the total amount of deductible expenses, including those described in section 62(2) (B), (C), and (D).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example: S, who is not a full-time outside salesman, received a salary of $20,000 and an expense allowance of $1,200 for the calendar year 1954. He expended $800 for travel, meals, and lodging while away from home, $500 for local transportation expenses and $300 for the entertainment of customers. His adjusted gross income is computed as follows:

Salary	$20,000		
Expense allowance	1,200		
Gross income		$21,200	
Less:			
Travel, meals and lodging while away from home	800		
Transportation expense	500		
Reimbursed expenses[1]	225		
		1,525	
Adjusted gross income			$19,675

[1] The amount of the reimbursement allocable to entertainment expenses is determined as follows:

Travel, meals, and lodging while away from home	$800
Transportation expense	500
Expenses deductible in arriving at adjusted gross income (whether or not reimbursed)	1,300

Entertainment expense	300
Total expenses	1,600
Deductible for adjusted gross income: 300/1,600 × $1,200 (expense allowance)	225

(g) Transportation expenses paid or incurred by an employee in connection with performance by him of services for his employer are deductible from gross income under part VI in computing adjusted gross income. "Transportation", as used in section 62(2)(C), is a narrower concept than "travel", as used in section 62(2)(B), and does not include meals and lodging. The term "transportation expense" includes only the cost of transporting the employee from one place to another in the course of his employment, while he is not away from home in a travel status. Thus, transportation costs may include cab fares, bus fares, and the like, and also a pro rata share of the employee's expenses of operating his automobile, including gas, oil, and depreciation. All transportation expenses must be allowable expenses under part VI (section 161 and following), subchapter B, chapter 1 of the Code, as ordinary and necessary expenses incurred during the taxable year in carrying on a trade or business as an employee. Transportation expenses do not include the cost of commuting to and from work; this cost constitutes a personal, living, or family expense and is not deductible. (See section 262.)

(h) The expenses of an employee attributable to the trade or business carried on as an outside salesman which are allowed by part VI are deductible from gross income in computing adjusted gross income. An outside salesman is an individual who solicits business as a full-time salesman for his employer away from his employer's place of business. The term "outside salesman" does not include a taxpayer whose principal activities consist of service and delivery. For example, a bread driver-salesman or a milk driver-salesman would not be included within the definition. However, an outside salesman may perform incidental inside activities at his employer's place of business, such as writing up and transmitting orders and spending short periods at the employer's place of business to make and receive telephone calls, without losing his classification as an outside salesman.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6722, 29 FR 5069, Apr. 14, 1964; T.D. 6796, 30 FR 1037, Feb. 2, 1965; T.D. 7399, 41 FR 5099, Feb. 4, 1976; T.D. 7512, 42 FR 54947, Oct. 12, 1977]

§ 1.63-1 Change of treatment with respect to the zero bracket amount and itemizes deductions.

(a) *In general.* An individual who files a return on which the individual itemizes deductions in accordance with section 63(g) may later make a change of treatment by recomputing taxable income for the taxable year to which that return relates without itemizing deductions. Similarly, an individual who files a return on which the individual computes taxable income without itemizing deductions may later make a change of treatment by itemizing deductions in accordance with section 63(g) in recomputing taxable income for the taxable year to which that return relates.

(b) *No extension of time for claiming credit or refund.* A change of treatment described in paragraph (a) of this section does not extend the period of time prescribed in section 6511 within which the taxpayer may make a claim for credit or refund of tax.

(c) *Special requirements if spouse filed separate return*—(1) *Requirements.* If the spouse of the taxpayer filed a separate return for a taxable year corresponding to the taxable year of the taxpayer, the taxpayer may not make a change of treatment described in paragraph (a) of this section for that year unless—

(i) The spouse makes a change of treatment on the separate return consistent with the change of treatment sought by the taxpayer; and

(ii) The taxpayer and the taxpayer's spouse file a consent in writing to the assessment of any deficiency of either spouse to the extent attributable to the change of treatment, even though the assessment of the deficiency would otherwise be prevented by the operation of any law or rule of law. The consent must be filed with the district director for the district in which the taxpayer applies for the change of

treatment, and the period during which a deficiency may be assessed shall be established by agreement of the spouses and the district director.

(2) *Corresponding taxable year.* A taxable year of one spouse corresponds to a taxable year of the other spouse if both taxable years end in the same calendar year. If the taxable year of one spouse ends with death, however, the corresponding taxable year of the surviving spouse is that in which the death occurs.

(d) *Inapplicable if tax liability has been compromised.* The taxpayer may not make a change of treatment described in paragraph (a) of this section for any taxable year if—

(1) The tax liability of the taxpayer for the taxable year has been compromised under section 7122; or

(2) The tax liability of the taxpayer's spouse for a taxable year corresponding to the taxable year of the taxpayer has been compromised under section 7122. See paragraph (c)(2) of this section for the determination of a corresponding taxable year.

(e) *Effective date.* This section applies to taxable years beginning after 1976.

[T.D. 7585, 44 FR 1105, Jan. 4, 1979]

Items Specifically Included in Gross Income

§ 1.71-1 Alimony and separate maintenance payments; income to wife or former wife.

(a) *In general.* Section 71 provides rules for treatment in certain cases of payments in the nature of or in lieu of alimony or an allowance for support as between spouses who are divorced or separated. For convenience, the payee spouse will hereafter in this section be referred to as the "wife" and the spouse from whom she is divorced or separated as the "husband." See section 7701(a)(17). For rules relative to the deduction by the husband of periodic payments not attributable to transferred property, see section 215 and the regulations thereunder. For rules relative to the taxable status of income of an estate or trust in case of divorce, etc., see section 682 and the regulations thereunder.

(b) *Alimony or separate maintenance payments received from the husband*—(1) *Decree of divorce or separate maintenance.* (i) In the case of divorce or legal separation, paragraph (1) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her after a decree of divorce or of separate maintenance. Such periodic payments must be made in discharge of a legal obligation imposed upon or incurred by the husband because of the marital or family relationship under a court order or decree divorcing or legally separating the husband and wife or a written instrument incident to the divorce status or legal separation status.

(ii) For treatment of payments attributable to property transferred (in trust or otherwise), see paragraph (c) of this section.

(2) *Written separation agreement.* (i) Where the husband and wife are separated and living apart and do not file a joint income tax return for the taxable year, paragraph (2) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her pursuant to a written separation agreement executed after August 16, 1954. The periodic payments must be made under the terms of the written separation agreement after its execution and because of the marital or family relationship. Such payments are includible in the wife's gross income whether or not the agreement is a legally enforceable instrument. Moreover, if the wife is divorced or legally separated subsequent to the written separation agreement, payments made under such agreement continue to fall within the provisions of section 71(a)(2).

(ii) For purposes of section 71(a)(2) any written separation agreement executed on or before August 16, 1954, which is altered or modified in writing by the parties in any material respect after that date will be treated as an agreement executed after August 16, 1954, with respect to payments made after the date of alteration or modification.

(iii) For treatment of payments attributable to property transferred (in

trust or otherwise), see paragraph (c) of this section.

(3) *Decree for support.* (i) Where the husband and wife are separated and living apart and do not file a joint income tax return for the taxable year, paragraph (3) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her after August 16, 1954, from her husband under any type of court order or decree (including an interlocutory decree of divorce or a decree of alimony pendente lite) entered after March 1, 1954, requiring the husband to make the payments for her support or maintenance. It is not necessary for the wife to be legally separated or divorced from her husband under a court order or decree; nor is it necessary for the order or decree for support to be for the purpose of enforcing a written separation agreement.

(ii) For purposes of section 71(a)(3), any decree which is altered or modified by a court order entered after March 1, 1954, will be treated as a decree entered after such date.

(4) *Scope of section 71(a).* Section 71(a) applies only to payments made because of the family or marital relationship in recognition of the general obligation to support which is made specific by the decree, instrument, or agreement. Thus, section 71(a) does not apply to that part of any periodic payment which is attributable to the repayment by the husband of, for example, a bona fide loan previously made to him by the wife, the satisfaction of which is specified in the decree, instrument, or agreement as a part of the general settlement between the husband and wife.

(5) *Year of inclusion.* Periodic payments are includible in the wife's income under section 71(a) only for the taxable year in which received by her. As to such amounts, the wife is to be treated as if she makes her income tax returns on the cash receipts and disbursements method, regardless of whether she normally makes such returns on the accrual method. However, if the periodic payments described in section 71(a) are to be made by an estate or trust, such periodic payments are to be included in the wife's taxable year in which they are includible according to the rules as to income of estates and trusts provided in sections 652, 662, and 682, whether or not such payments are made out of the income of such estates or trusts.

(6) *Examples.* The foregoing rules are illustrated by the following examples in which it is assumed that the husband and wife file separate income tax returns on the calendar year basis:

Example (1). W files suit for divorce from H in 1953. In consideration of W's promise to relinquish all marital rights and not to make public H's financial affairs, H agrees in writing to pay $200 a month to W during her lifetime if a final decree of divorce is granted without any provision for alimony. Accordingly, W does not request alimony and no provision for alimony is made under a final decree of divorce entered December 31, 1953. During 1954, H pays W $200 a month, pursuant to the promise. The $2,400 thus received by W is includible in her gross income under the provisions of section 71(a)(1). Under section 215, H is entitled to a deduction of $2,400 from his gross income.

Example (2). During 1945, H and W enter into an antenuptial agreement, under which, in consideration of W's relinquishment of all marital rights (including dower) in H's property, and, in order to provide for W's support and household expenses, H promises to pay W $200 a month during her lifetime. Ten years after their marriage, W sues H for divorce but does not ask for or obtain alimony because of the provision already made for her support in the antenuptial agreement. Likewise, the divorce decree is silent as to such agreement and H's obligation to support W. Section 71(a) does not apply to such a case. If, however, the decree were modified so as to refer to the antenuptial agreement, or if reference had been made to the antenuptial agreement in the court's decree or in a written instrument incident to the divorce status, section 71(a)(1) would require the inclusion in W's gross income of the payments received by her after the decree. Similarly, if a written separation agreement were executed after August 16, 1954, and incorporated the payment provisions of the antenuptial agreement, section 71(a)(2) would require the inclusion in W's income of payments received by W after W begins living apart from H, whether or not the divorce decree was subsequently entered and whether or not W was living apart from H when the separation agreement was executed, provided that such payments were made after such agreement was executed and pursuant to its terms. As to including such payments in W's

income, if made by a trust created under the antenuptial agreement, regardless of whether referred to in the decree or a later instrument, or created pursuant to the written separation agreement, see section 682 and the regulations thereunder.

Example (3). H and W are separated and living apart during 1954. W sues H for support and on February 1, 1954, the court enters a decree requiring H to pay $200 a month to W for her support and maintenance. No part of the $200 a month support payments is includible in W's income under section 71(a)(3) or deductible by H under section 215. If, however, the decree had been entered after March 1, 1954, or had been altered or modified by a court order entered after March 1, 1954, the payments received by W after August 16, 1954, under the decree as altered or modified would be includible in her income under section 71(a)(3) and deductible by H under section 215.

Example (4). W sues H for divorce in 1954. On January 15, 1954, the court awards W temporary alimony of $25 a week pending the final decree. On September 1, 1954, the court grants W a divorce and awards her $200 a month permanent alimony. No part of the $25 a week temporary alimony received prior to the decree is includible in W's income under section 71(a), but the $200 a month received during the remainder of 1954 by W is includible in her income for 1954. Under section 215, H is entitled to deduct such $200 payments from his income. If, however, the decree awarding W temporary alimony had been entered after March 1, 1954, or had been altered or modified by a court order entered after March 1, 1954, temporary alimony received by her after August 16, 1954, would be includible in her income under section 71(a)(3) and deductible by H under section 215.

(c) *Alimony and separate maintenance payments attributable to property.* (1) (i) In the case of divorce or legal separation, paragraph (1) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) attributable to property transferred, in trust or otherwise, and received by her after a decree of divorce or of separate maintenance. Such property must have been transferred in discharge of a legal obligation imposed upon or incurred by the husband because of the marital or family relationship under a decree of divorce or separate maintenance or under a written instrument incident to such divorce status or legal separation status.

(ii) Where the husband and wife are separated and living apart and do not file a joint income tax return for the taxable year, paragraph (2) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her which are attributable to property transferred, in trust or otherwise, under a written separation agreement executed after August 16, 1954. The property must be transferred because of the marital or family relationship. The periodic payments attributable to the property must be received by the wife after the written separation agreement is executed.

(iii) The periodic payments received by the wife attributable to property transferred under subdivisions (i) and (ii) of this subparagraph and includible in her gross income are not to be included in the gross income of the husband.

(2) The full amount of periodic payments received under the circumstances described in section 71(a) (1), (2), and (3) is required to be included in the gross income of the wife regardless of the source of such payments. Thus, it matters not that such payments are attributable to property in trust, to life insurance, endowment, or annuity contracts, or to any other interest in property, or are paid directly or indirectly by the husband from his income or capital. For example, if in order to meet an alimony or separate maintenance obligation of $500 a month the husband purchases or assigns for the benefit of his wife a commercial annuity contract paying such amount, the full $500 a month received by the wife is includible in her income, and no part of such amount is includible in the husband's income or deductible by him. See section 72(k) and the regulations thereunder. Likewise, if property is transferred by the husband, subject to an annual charge of $5,000, payable to his wife in discharge of his alimony or separate maintenance obligation under the divorce or separation decree or written instrument incident to the divorce status or legal separation status or if such property is transferred pursuant to a written separation agreement and

subject to a similar annual charge, the $5,000 received annually is, under section 71(a) (1) or (2), includible in the wife's income, regardless of whether such amount is paid out of income or principal of the property.

(3) The same rule applies to periodic payments attributable to property in trust. The full amount of periodic payments to which section 71(a) (1) and (2) applies is includible in the wife's income regardless of whether such payments are made out of trust income. Such periodic payments are to be included in the wife's income under section 71(a) (1) or (2) and are to be excluded from the husband's income even though the income of the trust would otherwise be includible in his income under subpart E, part I, subchapter J, chapter 1 of the Code, relating to trust income attributable to grantors and others as substantial owners. As to periodic payments received by a wife attributable to property in trust in cases to which section 71(a) (1) or (2) does not apply because the husband's obligation is not specified in the decree or an instrument incident to the divorce status or legal separation status or the property was not transferred under a written separation agreement, see section 682 and the regulations thereunder.

(4) Section 71(a) (1) or (2) does not apply to that part of any periodic payment attributable to that portion of any interest in property transferred in discharge of the husband's obligation under the decree or instrument incident to the divorce status or legal separation status, or transferred pursuant to the written separation agreement, which interest originally belonged to the wife. It will apply, however, if she received such interest from her husband in contemplation of or as an incident to the divorce or separation without adequate and full consideration in money or money's worth, other than the release of the husband or his property from marital obligations. An example of the first rule is a case where the husband and wife transfer securities, which were owned by them jointly, in trust to pay an annuity to the wife. In this case, the full amount of that part of the annuity received by the wife attributable to the husband's interest in the securities transferred in discharge of his obligation under the decree, or instrument incident to the divorce status or legal separation status, or transferred under the written separation agreement, is taxable to her under section 71(a) (1) or (2), while that portion of the annuity attributable to the wife's interest in the securities so transferred is taxable to her only to the extent it is out of trust income as provided in part I (sections 641 and following), subchapter J, chapter 1 of the Code. If, however, the husband's transfer to his wife is made before such property is transferred in discharge of his obligation under the decree or written instrument, or pursuant to the separation agreement in an attempt to avoid the application of section 71(a) (1) or (2) to part of such payments received by his wife, such transfers will be considered as a part of the same transfer by the husband of his property in discharge of his obligation or pursuant to such agreement. In such a case, section 71(a) (1) or (2) will be applied to the full amount received by the wife. As to periodic payments received under a joint purchase of a commercial annuity contract, see section 72 and the regulations thereunder.

(d) *Periodic and installment payments.* (1) In general, installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree, instrument, or agreement are not considered "periodic payments" and therefore are not to be included under section 71(a) in the wife's income.

(2) An exception to the general rule stated in subparagraph (1) of this paragraph is provided, however, in cases where such principal sum, by the terms of the decree, instrument, or agreement, may be or is to be paid over a period ending more than 10 years from the date of such decree, instrument, or agreement. In such cases, the installment payment is considered a periodic payment for the purposes of section 71(a) but only to the extent that the installment payment, or sum of the installment payments, received during the wife's taxable year does not exceed 10 percent of the principal

sum. This 10-percent limitation applies to installment payments made in advance but does not apply to delinquent installment payments for a prior taxable year of the wife made during her taxable year.

(3) (i) Where payments under a decree, instrument, or agreement are to be paid over a period ending 10 years or less from the date of such decree, instrument, or agreement, such payments are not installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree, instrument, or agreement (and are considered periodic payments for the purposes of section 71(a)) only if such payments meet the following two conditions:

(*a*) Such payments are subject to any one or more of the contingencies of death of either spouse, remarriage of the wife, or change in the economic status of either spouse, and

(*b*) Such payments are in the nature of alimony or an allowance for support.

(ii) Payments meeting the requirements of subdivision (i) are considered periodic payments for the purposes of section 71(a) regardless of whether—

(*a*) The contingencies described in subdivision (i)(*a*) of this subparagraph are set forth in the terms of the decree, instrument, or agreement, or are imposed by local law, or

(*b*) The aggregate amount of the payments to be made in the absence of the occurrence of the contingencies described in subdivision (i)(*a*) of this subparagraph is explicitly stated in the decree, instrument, or agreement or may be calculated from the face of the decree, instrument, or agreement, or

(*c*) The total amount which will be paid may be calculated actuarially.

(4) Where payments under a decree, instrument, or agreement are to be paid over a period ending more than ten years from the date of such decree, instrument, or agreement, but where such payments meet the conditions set forth in subparagraph (3)(i) of this paragraph, such payments are considered to be periodic payments for the purpose of section 71 without regard to the rule set forth in subparagraph (2) of this paragraph. Accordingly, the rules set forth in subparagraph (2) of this paragraph are not applicable to such payments.

(5) The rules as to periodic and installment payments are illustrated by the following examples:

Example (1). Under the terms of a written instrument, H is required to make payments to W which are in the nature of alimony, in the amount of $100 a month for nine years. The instrument provides that if H or W dies the payments are to cease. The payments are periodic.

Example (2). The facts are the same as in example (1) except that the written instrument explicitly provides that H is to pay W the sum of $10,800 in monthly payments of $100 over a period of nine years. The payments are periodic.

Example (3). Under the terms of a written instrument, H is to pay W $100 a month over a period of nine years. The monthly payments are not subject to any of the contingencies of death of H or W, remarriage of W, or change in the economic status of H or W under the terms of the written instrument or by reason of local law. The payments are not periodic.

Example (4). A divorce decree in 1954 provides that H is to pay W $20,000 each year for the next five years, beginning with the date of the decree, and then $5,000 each year for the next ten years. Assuming the wife makes her returns on the calendar year basis, each payment received in the years 1954 to 1958, inclusive, is treated as a periodic payment under section 71(a)(1), but only to the extent of 10 percent of the principal sum of $150,000. Thus, for such taxable years, only $15,000 of the $20,000 received is includible under section 71(a)(1) in the wife's income and is deductible by the husband under section 215. For the years 1959 to 1968, inclusive, the full $5,000 received each year by the wife is includible in her income and is deductible from the husband's income.

(e) *Payments for support of minor children.* Section 71(a) does not apply to that part of any periodic payment which, by the terms of the decree, instrument, or agreement under section 71(a), is specifically designated as a sum payable for the support of minor children of the husband. The statute prescribes the treatment in cases where an amount or portion is so fixed but the amount of any periodic payment is less than the amount of the periodic payment specified to be made. In such cases, to the extent of the

amount which would be payable for the support of such children out of the originally specified periodic payment, such periodic payment is considered a payment for such support. For example, if the husband is by terms of the decree, instrument, or agreement required to pay $200 a month to his divorced wife, $100 of which is designated by the decree, instrument, or agreement to be for the support of their minor children, and the husband pays only $150 to his wife, $100 is nevertheless considered to be a payment by the husband for the support of the children. If, however, the periodic payments are received by the wife for the support and maintenance of herself and of minor children of the husband without such specific designation of the portion for the support of such children, then the whole of such amounts is includible in the income of the wife as provided in section 71(a). Except in cases of a designated amount or portion for the support of the husband's minor children, periodic payments described in section 71(a) received by the wife for herself and any other person or persons are includible in whole in the wife's income, whether or not the amount or portion for such other person or persons is designated.

§ 1.71-2 Effective date; taxable years ending after March 31, 1954, subject to the Internal Revenue Code of 1939.

Pursuant to section 7851(a)(1)(C), the regulations prescribed in § 1.71-1, to the extent that they relate to payments under a written separation agreement executed after August 16, 1954, and to the extent that they relate to payments under a decree for support received after August 16, 1954, under a decree entered after March 1, 1954, shall also apply to taxable years beginning before January 1, 1954, and ending after August 16, 1954, although such years are subject to the Internal Revenue Code of 1939.

§ 1.72-1 Introduction.

(a) *General principle.* Section 72 prescribes rules relating to the inclusion in gross income of amounts received under a life insurance, endowment, or annuity contract unless such amounts are specifically excluded from gross income under other provisions of chapter 1 of the Code. In general, these rules provide that amounts subject to the provisions of section 72 are includible in the gross income of the recipient except to the extent that they are considered to represent a reduction or return of premiums or other consideration paid.

(b) *Amounts to be considered as a return of premiums.* For the purpose of determining the extent to which amounts received represent a reduction or return of premiums or other consideration paid, the provisions of section 72 distinguish between "amounts received as an annuity" and "amounts not received as an annuity". In general, "amounts received as an annuity" are amounts which are payable at regular intervals over a period of more than one full year from the date on which they are deemed to begin, provided the total of the amounts so payable or the period for which they are to be paid can be determined as of that date. See paragraph (b) (2) and (3) of § 1.72-2. Any other amounts to which the provisions of section 72 apply are considered to be "amounts not received as an annuity". See § 1.72-11.

(c) *"Amounts received as an annuity."* (1) In the case of "amounts received as an annuity" (other than certain employees' annuities described in section 72(d) and in § 1.72-13), a proportionate part of each amount so received is considered to represent a return of premiums or other consideration paid. The proportionate part of each annuity payment which is thus excludable from gross income is determined by the ratio which the investment in the contract as of the date on which the annuity is deemed to begin bears to the expected return under the contract as of that date. See § 1.72-4.

(2) In the case of employees' annuities of the type described in section 72(d), no amount received as an annuity in a taxable year to which the Internal Revenue Code of 1954 applies is includible in the gross income of a recipient until the aggregate of all amounts received thereunder and excluded from gross income under the applicable income tax law exceeds the consideration contributed (or deemed

contributed) by the employee under § 1.72-8. Thereafter, all amounts so received are includible in the gross income of the recipient. See § 1.72-13.

(d) *"Amounts not received as an annuity".* In the case of "amounts not received as an annuity", if such amounts are received after an annuity has begun and during its continuance, amounts so received are generally includible in the gross income of the recipient. Amounts not received as an annuity which are received at any other time are generally includible in the gross income of the recipient only to the extent that such amounts, when added to all amounts previously received under the contract which were excludable from the gross income of the recipient under the income tax law applicable at the time of receipt, exceed the premiums or other consideration paid (see § 1.72-11). However, if the aggregate of premiums or other consideration paid for the contract includes amounts for which a deduction was allowed under section 404 as contributions on behalf of an owner-employee, the amounts received under the circumstances of the preceding sentence shall be includible in gross income until the amount so included equals the amount for which the deduction was so allowed. See paragraph (b) of § 1.72-17.

(e) *Classification of recipients.* For the purpose of the regulations under section 72, a recipient shall be considered an "annuitant" if he receives amounts under an annuity contract during the period that the annuity payments are to continue, whether for a term certain or during the continuing life or lives of the person or persons whose lives measure the duration of such annuity. However, a recipient shall be considered a "beneficiary" rather than an "annuitant" if the amounts he receives under a contract are received after the term of the annuity for a life or lives has expired and such amounts are paid by reason of the fact that the contract guarantees that payments of some minimum amount or for some minimum period shall be made. For special rules with respect to beneficiaries, see paragraphs (a)(1)(iii) and (c) of § 1.72-11.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10134, Sept. 17, 1963]

§ 1.72-2 Applicability of section.

(a) *Contracts.* (1) The contracts under which amounts paid will be subject to the provisions of section 72 include contracts which are considered to be life insurance, endowment, and annuity contracts in accordance with the customary practice of life insurance companies. For the purposes of section 72, however, it is immaterial whether such contracts are entered into with an insurance company. The term "endowment contract" also includes the "face-amount certificates" described in section 72(l).

(2) If two or more annuity obligations or elements to which section 72 applies are acquired for a single consideration, such as an obligation to pay an annuity to A for his life accompanied by an obligation to pay an annuity to B for his life, there being a single consideration paid for both obligations (whether paid by one or more persons in equal or different amounts, and whether paid in a single sum or otherwise), such annuity elements shall be considered to comprise a single contract for the purpose of the application of section 72 and the regulations thereunder. For rules relating to the allocation of investment in the contract in the case of annuity elements payable to two or more persons, see paragraph (b) of § 1.72-6.

(3) (i) Sections 402 and 403 provide that certain distributions by employees' trusts and certain payments under employee plans are taxable under section 72. For taxable years beginning before January 1, 1964, section 72(e)(3), as in effect before such date, does not apply to such distributions or payments. For purposes of applying section 72 to such distributions and payments (other than those described in subdivision (iii) of this subparagraph), each separate program of the employer consisting of interrelated contributions and benefits shall be considered a single contract. Therefore, all distributions or payments (other than those described in subdivision (iii) of this subparagraph) which are attributable to a separate program

of interrelated contributions and benefits are considered as received under a single contract. A separate program of interrelated contributions and benefits may be financed by the purchase from an insurance company of one or more group contracts or one or more individual contracts, or may be financed partly by the purchase of contracts from an insurance company and partly through an investment fund, or may be financed completely through an investment fund. A program may be considered separate for purposes of section 72 although it is only a part of a plan which qualifies under section 401. There may be several trusts under one separate program, or several separate programs may make use of a single trust. See, however, subdivision (iii) of this subparagraph for rules relating to what constitutes a "contract" for purposes of applying section 72 to distributions commencing before October 20, 1960.

(ii) The following types of benefits, and the contributions used to provide them, are examples of separate programs of interrelated contributions and benefits:

(*a*) Definitely determinable retirement benefits.

(*b*) Definitely determinable benefits payable prior to retirement in case of disability.

(*c*) Life insurance.

(*d*) Accident and health insurance.

However, retirement benefits and life insurance will be considered part of a single separate program of interrelated contributions and benefits to the extent they are provided under retirement income, endowment, or other contracts providing life insurance protection. See examples (6), (7), and (8) contained in subdivision (iv) of this subparagraph for illustrations of the principles of this subdivision. See, also, § 1.72-15 for rules relating to the taxation of amounts received under an employee plan which provides both retirement benefits and accident and health benefits.

(iii) If any amount which is taxable under section 72 by reason of section 402 or 403 is actually distributed or made available to any person under an employees' trust or plan (other than the Civil Service Retirement Act, 5 U.S.C. ch. 14) before October 20, 1960, section 72 shall, notwithstanding any other provisions in this subparagraph, be applied to all the distributions with respect to such person (or his beneficiaries) under such trust or plan (whether received before or after October 20, 1960) as though such distributions were provided under a single contract. For purposes of applying section 72 to distributions to which this subdivision applies, therefore, the term "contract" shall be considered to include the entire interest of an employee in each trust or plan described in sections 402 and 403 to the extent that distributions thereunder are subject to the provisions of section 72. Section 72 shall be applied to distributions received under the Civil Service Retirement Act in the manner prescribed in subdivision (i) of this subparagraph (see example (4) in subdivision (iv) of this subparagraph).

(iv) The application of this subparagraph may be illustrated by the following examples:

Example (1). On January 1, 1961, X Corporation established a noncontributory profit-sharing plan for its employees providing that the amount standing to the account of each participant will be paid to him at the time of his retirement and also established a contributory pension plan for its employees providing for the payment to each participant of a lifetime pension after retirement. The profit-sharing plan is designed to enable the employees to participate in the profits of X Corporation; the amount of the contributions to it are determined by reference to the profits of X Corporation; and the amount of any distribution is determined by reference to the amount of contributions made on behalf of any participant and the earnings thereon. On the other hand, the pension plan is designed to provide a lifetime pension for a retired employee; the amount of the pension is to be determined by a formula set forth in the plan; and the amount of contributions to the plan is the amount necessary to provide such pensions. In view of the fact that each of these plans constitutes a separate program of interrelated contributions and benefits, the distributions from each shall be treated as received under a separate contract. If these plans had been established before October 20, 1960, then, in the case of an employee who receives a distribution under the plans before October 20, 1960, the determination as to whether that distribution and all subsequent distributions to such

employee are received under a single contract or under more than one contract shall be made by applying the rules in subdivision (iii) of this subparagraph. On the other hand, in the case of an employee who does not receive any distribution under these plans before October 20, 1960, the determination as to whether distributions to him are received under a single contract or under more than one contract shall be made in accordance with the rules illustrated by this example.

Example (2). On January 1, 1961, Z Corporation established a profit-sharing plan for its employees providing that any employee may make contributions, not in excess of 6 percent of his compensation, to a trust and that the employer would make matching contributions out of profits. Under the plan, a participant may receive a periodic distribution of the amount standing in his account during any period that he is absent from work due to a personal injury or sickness. On separation from service, the participant is entitled to receive a distribution of the balance standing in his account in accordance with one of several options. One option provides for the immediate distribution of one-half of the account and for the periodic distribution of the remaining one-half of the account. In addition, any participant may, after the completion of five years of participation, withdraw any part of his account, but in the case of such a withdrawal, the participant forfeits his rights to participate in the plan for a period of two years. Thus, a participant may receive distributions before separation from service; he may receive a distribution of a lump sum upon separation from service; he may also receive periodic distributions upon separation from service. However, since it is the total amount received under all the options that is interrelated with the contributions to the plan and not the amount received under any one option, this profit-sharing plan consists of only one separate program of interrelated contributions and benefits and all distributions under the plan (regardless of the option under which received) are treated as received under one contract. However, if, instead of providing that the amount standing in an employee's account would be paid to him during any period that he is absent from work due to a personal injury or sickness, the plan provided that a portion of the amount in the employee's account would be used to purchase incidental accident and health insurance, this plan would consist of two separate programs of interrelated contributions and benefits. The accident and health insurance, and the contributions used to purchase it, would be considered as one separate program of interrelated contributions and benefits and, therefore, a separate contract; whereas, the remaining contributions and benefits would be considered another separate program of interrelated contributions and benefits and, consequently, another separate contract.

Example (3). On January 1, 1961, N Corporation established a profit-sharing plan for its employees providing that the employees may make contributions, not in excess of 6 percent of their compensation, to a trust and that N Corporation would make matching contributions out of its profits. Under the plan, the employee may elect each year to have his and the employer's contributions for such year placed in either a savings arrangement or a retirement arrangement. Such an election is irrevocable. Under the savings arrangement, contributions to such arrangement for any one year and the earnings thereon will be distributed five years later. The retirement arrangement provides that all contributions thereto and the earnings thereon will be distributed when the employee is separated from the service of N Corporation. Since the distributions under the retirement arrangement are attributable solely to the contributions made to such arrangement and are not affected in any manner by contributions or distributions under the savings arrangement or any other plan, such distributions are treated as received under a separate program of interrelated contributions and benefits. Similarly, since distributions during any year under the savings arrangement are attributable only to contributions to such arrangement made during the fifth preceding year and are not affected in any manner by any other contributions to or distributions from such arrangement or any other plan, the savings arrangement constitutes a series of separate programs of interrelated contributions and benefits. The contributions to the savings arrangement for any year and the distribution in a subsequent year based thereon constitute a separate contract for purposes of section 72.

Example (4). The Civil Service Retirement Act (5 U.S.C. Ch. 14) which provides retirement benefits for participating employees, consists of a compulsory program and a voluntary program. Under the compulsory program, all participating employees are required to make certain contributions and, upon retirement, are provided retirement benefits computed on the basis of compensation and length of service. Under the voluntary program, such participating employees are permitted to make contributions in addition to those required under the compulsory program and, upon retirement, are provided additional retirement benefits computed on the basis of their voluntary contributions. Distributions received under the Act constitute distributions from two separate contracts for purposes of section 72. Distributions received under the compulsory program are considered as received

under a separate program of interrelated contributions and benefits since they are computed solely under the compulsory program and are not affected by any contributions or distributions under the voluntary program or under any other plan. For similar reasons, distributions which are attributable to the voluntary contributions are considered as received under a separate program of interrelated contributions and benefits.

Example (5). On January 1, 1961, M Corporation established a contributory pension plan for its employees and created a trust to which it makes contributions to fund such plan. The plan provides that each participant will receive after age 65 a pension of 1½ percent of his compensation for each year of service performed subsequent to the establishment of such plan. In order to fund part of the benefits under the plan, the trustee purchased a group annuity contract. The remaining part of the benefits are to be paid out of a separate investment fund. This pension plan constitutes a single program of interrelated contributions and benefits and, therefore, all distributions received by an employee under the plan are considered as received under a single contract for purposes of section 72.

Example (6). On January 1, 1961, Y Corporation established a noncontributory pension plan (including incidental death benefits) for its employees and created a trust to which it makes contributions to fund such plan. The plan provides that each participant will receive after age 65 a pension of 1½ percent of his compensation for each year of service performed subsequent to the establishment of such plan. In addition, such plan provides for the payment of a death benefit if the employee dies before age 65. The trustee funded the death benefits through the purchase of a group term insurance policy and funded the retirement benefits through the purchase of a group annuity contract. Because of a subsequent change in funding from the deferred annuity method to the deposit administration method, the trustee purchased a second group annuity contract to provide the retirement benefits under the plan accruing after the effective date of the change in method of funding. Thus, retirement benefits distributed to an employee whose service with Y Corporation commenced before the effective date of the change in method of funding will be attributable to both group annuity contracts. This pension plan includes two separate programs of interrelated contributions and benefits. The death benefits, and the contributions required to provide them, are considered as one separate program of interrelated contributions and benefits; whereas, the retirement benefits, and the contributions required to provide them, are considered as another separate program of interrelated contributions and benefits. Therefore, any retirement benefits received by an employee, whether attributable to one or both of the group annuity contracts, shall be considered as received under a single contract for purposes of section 72. In determining the tax treatment of any such retirement benefits under section 72, no amount of the premiums used to purchase the group term insurance policy shall be taken into account, since such premiums, and the death benefits which they purchased, constitute a separate program of interrelated contributions and benefits.

Example (7). Assume the same facts as in example (6) except that, in lieu of funding the benefits in the manner described in that example, the trustee purchased individual retirement income contracts from an insurance company. Additional individual retirement income contracts are purchased in order to fund any increase in benefits resulting from increases in salary. Therefore, distributions to a particular employee may be attributable to a single retirement income contract or to more than one such contract. All distributions received by an employee under the pension plan, whether attributable to one or more retirement income contracts and whether made directly from the insurance company to the employee or made through the trustee, are considered as received under a single contract for purposes of section 72. For rules relating to the tax treatment of contributions and distributions under retirement income, endowment, or other life insurance contracts purchased by a trust described in section 401(a) and exempt under section 501(a), see paragraph (a) (2), (3), and (4) of § 1.402(a)-1.

Example (8). Assume the same facts as in example (6) except that, in lieu of funding the benefits in the manner described in that example, the trustee funded the death benefits and part of the retirement benefits by purchasing individual retirement income contracts from an insurance company. The remaining part of the retirement benefits (such as any increase in benefits resulting from increases in salary) are to be paid out of a separate investment fund. This pension plan includes, with respect to each participant, two separate contracts for purposes of section 72. The retirement income contract purchased by the trust for each participant is a separate program of interrelated contributions and benefits and all distributions attributable to such contract (whether made directly from the insurance company to the employee or made through the trustee) are considered as received under a single contract. For rules relating to the tax treatment of contributions and distributions under retirement income, endowment, or other life insurance contracts purchased by a trust described in section 401(a) and

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exempt under section 501(a), see paragraph (a) (2), (3), and (4) of § 1.402(a)-1. The remaining distributions under the plan are considered as received under another separate program of interrelated contributions and benefits.

(b) *Amounts.* (1)(i) In general, the amounts to which section 72 applies are any amounts received under the contracts described in paragraph (a)(1) of this section. However, if such amounts are specifically excluded from gross income under other provisions of chapter 1 of the Code, section 72 shall not apply for the purpose of including such amounts in gross income. For example, section 72 does not apply to amounts received under a life insurance contract if such amounts are paid by reason of the death of the insured and are excludable from gross income under section 101(a). See also sections 101(d), relating to proceeds of life insurance paid at a date later than death, and 104(a)(4), relating to compensation for injuries or sickness.

(ii) Section 72 does not exclude from gross income any amounts received under an agreement to hold an amount and pay interest thereon. See paragraph (a) of § 1.72-14. However, section 72 does apply to amounts received by a surviving annuitant under a joint and survivor annuity contract since such amounts are not considered to be paid by reason of the death of an insured. For a special deduction for the estate tax attributable to the inclusion of the value of the interest of a surviving annuitant under a joint and survivor annuity contract in the estate of the deceased primary annuitant, see section 691(d) and the regulations thereunder.

(2) Amounts subject to section 72 in accordance with subparagraph (1) of this paragraph are considered "amounts received as an annuity" only in the event that all of the following tests are met:

(i) They must be received on or after the "annuity starting date" as that term is defined in paragraph (b) of § 1.72-4;

(ii) They must be payable in periodic installments at regular intervals (whether annually, semiannually, quarterly, monthly, weekly, or otherwise) over a period of more than one full year from the annuity starting date; and

(iii) Except as indicated in subparagraph (3) of this paragraph, the total of the amounts payable must be determinable at the annuity starting date either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both, in conjunction with such terms and in accordance with sound actuarial theory.

For the purpose of determining whether amounts subject to section 72(d) and § 1.72-13 are "amounts received as an annuity", however, the provisions of subdivision (i) of this subparagraph shall be disregarded. In addition, the term "amounts received as an annuity" does not include amounts received to which the provisions of paragraph (b) or (c) of § 1.72-11 apply, relating to dividends and certain amounts received by a beneficiary in the nature of a refund. If an amount is to be paid periodically until a fund plus interest at a fixed rate is exhausted, but further payments may be made thereafter because of earnings at a higher interest rate, the requirements of subdivision (iii) of this subparagraph are met with respect to the payments determinable at the outset by means of computations involving the fixed interest rate, but any payments received after the expiration of the period determinable by such computations shall be taxable as dividends received after the annuity starting date in accordance with paragraph (b)(2) of § 1.72-11.

(3) (i) Notwithstanding the requirement of subparagraph (2)(iii) of this paragraph, if amounts are to be received for a definite or determinable time (whether for a period certain or for a life or lives) under a contract which provides:

(*a*) That the amount of the periodic payments may vary in accordance with investment experience (as in certain profit-sharing plans), cost of living indices, or similar fluctuating criteria, or

(*b*) For specified payments the value of which may vary for income tax purposes, such as in the case of any annuity payable in foreign currency,

each such payment received shall be considered as an amount received as an annuity only to the extent that it does not exceed the amount computed by dividing the investment in the contract, as adjusted for any refund feature, by the number of periodic payments anticipated during the time that the periodic payments are to be made. If payments are to be made more frequently than annually, the amount so computed shall be multiplied by the number of periodic payments to be made during the taxable year for the purpose of determining the total amount which may be considered received as an annuity during such year. To this extent, the payments received shall be considered to represent a return of premium or other consideration paid and shall be excludable from gross income in the taxable year in which received. See paragraph (d) (2) and (3) of § 1.72-4. To the extent that the payments received under the contract during the taxable year exceed the total amount thus considered to be received as an annuity during such year, they shall be considered to be amounts not received as an annuity and shall be included in the gross income of the recipient. See section 72(e) and paragraph (b)(2) of § 1.72-11.

(ii) For purposes of subdivision (i) of this subparagraph, the number of periodic payments anticipated during the time payments are to be made shall be determined by multiplying the number of payments to be made each year (*a*) by the number of years payments are to be made, or (*b*) if payments are to be made for a life or lives, by the multiple found by the use of the appropriate tables contained in § 1.72-9, as adjusted in accordance with the table in paragraph (a)(2) of § 1.72-5.

(iii) For an example of the computation to be made in accordance with this subparagraph and a special election which may be made in a taxable year subsequent to a taxable year in which the total payments received under a contract described in this subparagraph are less than the total of the amounts excludable from gross income in such year under subdivision (i) of this subparagraph, see paragraph (d)(3) of § 1.72-4.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6497, 25 FR 10019, Oct. 20, 1960; T.D. 6885, 31 FR 7798, June 2, 1966]

§ 1.72-3 Excludable amounts not income.

In general, amounts received under contracts described in paragraph (a)(1) of § 1.72-2 are not to be included in the income of the recipient to the extent that such amounts are excludable from gross income as the result of the application of section 72 and the regulations thereunder.

§ 1.72-4 Exclusion ratio.

(a) *General rule.* (1) (i) To determine the proportionate part of the total amount received each year as an annuity which is excludable from the gross income of a recipient in the taxable year of receipt (other than amounts received under (*a*) certain employee annuities described in section 72(d) and § 1.72-13, or (*b*) certain annuities described in section 72(o) and § 1.122-1), an exclusion ratio is to be determined for each contract. In general, this ratio is determined by dividing the investment in the contract as found under § 1.72-6 by the expected return under such contract as found under § 1.72-5. Where a single consideration is given for a particular contract which provides for two or more annuity elements, an exclusion ratio shall be determined for the contract as a whole by dividing the investment in such contract by the aggregate of the expected returns under all the annuity elements provided thereunder. However, where the provisions of paragraph (b)(3) of § 1.72-2 apply to payments received under such a contract, see paragraph (b)(3) of § 1.72-6.

(ii) The exclusion ratio for the particular contract is then applied to the total amount received as an annuity during the taxable year by each recipient. See, however, paragraph (e)(3) of § 1.72-5. Any excess of the total amount received as an annuity during the taxable year over the amount determined by the application of the exclusion ratio to such total amount shall be included in the gross income

of the recipient for the taxable year of receipt.

(2) The principles of subparagraph (1) may be illustrated by the following example:

Example. Taxpayer A purchased an annuity contract providing for payments of $100 per month for a consideration of $12,650. Assuming that the expected return under this contract is $16,000, the exclusion ratio to be used by A is $12,650÷$16,000; or 79.1 percent (79.06 rounded to the nearest tenth). If 12 such monthly payments are received by A during his taxable year, the total amount he may exclude from his gross income in such year is $949.20 ($1,200×79.1 percent). The balance of $250.80 ($1,200 less $949.20) is the amount to be included in gross income. If A instead received only five such payments during the year, he should exclude $395.50 ($500×79.1 percent) of the total amounts received.

For an example of the computation of the exclusion ratio in cases where two annuity elements are acquired for a single consideration, see paragraph (b)(1) of § 1.72-6.

(3) The exclusion ratio shall be applied only to amounts received as an annuity within the meaning of that term under paragraph (b) (2) and (3) of § 1.72-2. Where the periodic payments increase in amount after the annuity starting date in a manner not provided by the terms of the contract at such date, the portion of such payments representing the increase is not an amount received as an annuity. For the treatment of amounts not received as an annuity, see section 72(e) and § 1.72-11. For special rules where paragraph (b)(3) of § 1.72-2 applies to amounts received, see paragraph (d)(3) of this section.

(4) After an exclusion ratio has been determined for a particular contract, it shall be applied to any amounts received as an annuity thereunder unless or until one of the following occurs:

(i) The contract is assigned or transferred for a valuable consideration (see section 72(g) and paragraph (a) of § 1.72-10;

(ii) The contract matures or is surrendered, redeemed, or discharged in accordance with the provisions of paragraph (c) or (d) of § 1.72-11;

(iii) The contract is exchanged (or is considered to have been exchanged) in a manner described in paragraph (e) of § 1.72-11.

(b) *Annuity starting date.* (1) Except as provided in subparagraph (2) of this paragraph, the annuity starting date is the first day of the first period for which an amount is received as an annuity, except that if such date was before January 1, 1954, then the annuity starting date is January 1, 1954. The first day of the first period for which an amount is received as an annuity shall be whichever of the following is the later:

(i) The date upon which the obligations under the contract became fixed, or

(ii) The first day of the period (year, half-year, quarter, month, or otherwise, depending on whether payments are to be made annually, semiannually, quarterly, monthly, or otherwise) which ends on the date of the first annuity payment.

(2) Notwithstanding the provisions of paragraph (b)(1) of this section, the annuity starting date shall be determined in accordance with whichever of the following provisions is appropriate:

(i) In the case of a joint and survivor annuity contract described in section 72(i) and paragraph (b)(3) of § 1.72-5, the annuity starting date is January 1, 1954, or the first day of the first period for which an amount is received as an annuity by the surviving annuitant, whichever is the later;

(ii) In the case of the transfer of an annuity contract for a valuable consideration, as described in section 72(g) and paragraph (a) of § 1.72-10, the annuity starting date shall be January 1, 1954, or the first day of the first period for which the transferee received an amount as an annuity, whichever is the later;

(iii) If the provisions of paragraph (e) of § 1.72-11 apply to an exchange of one contract for another, or to a transaction deemed to be such an exchange, the annuity starting date of the contract received (or deemed received) in exchange shall be January 1, 1954, or the first day of the first period for which an amount is received as an annuity under such contract, whichever is the later; and

(iv) In the case of an employee who has retired from work because of personal injuries or sickness, and who is receiving amounts under a plan that is a wage continuation plan under section 105(d) and § 1.105-4, the annuity starting date shall be the date the employee reaches mandatory retirement age, as defined in § 1.105-4(a)(3)(i)(B). (See also §§ 1.72-15 and 1.105-6 for transitional and other special rules.)

(c) *Fiscal year taxpayers.* Fiscal year taxpayers receiving amounts as annuities in a taxable year to which the Internal Revenue Code of 1954 applies shall determine the annuity starting date in accordance with section 72(c)(4) and this section. The annuity starting date for fiscal year taxpayers receiving amounts as an annuity in a taxable year to which the Internal Revenue Code of 1939 applies shall be January 1, 1954, except where the first day of the first period for which an amount is received by such a taxpayer as an annuity is subsequent thereto and before the end of a fiscal year to which the Internal Revenue Code of 1939 applied. In such case, the latter date shall be the annuity starting date. In all cases where a fiscal year taxpayer received an amount as an annuity in a taxable year to which the Internal Revenue Code of 1939 applied and subsequent to the annuity starting date determined in accordance with the provisions of this paragraph, such amount shall be disregarded for the purposes of section 72 and the regulations thereunder.

(d) *Exceptions to the general rule.* (1) Where the provisions of section 72 would otherwise require an exclusion ratio to be determined, but the investment in the contract (determined under § 1.72-6) is an amount of zero or less, no exclusion ratio shall be determined and all amounts received under such a contract shall be includible in the gross income of the recipient for the purposes of section 72.

(2) Where the investment in the contract is equal to or greater than the total expected return under such contract found under § 1.72-5, the exclusion ratio shall be considered to be 100 percent and all amounts received as an annuity under such contract shall be excludable from the recipient's gross income. See, for example, paragraph (f)(1) of § 1.72-5.

(3) (i) If a contract provides for payments to be made to a taxpayer in the manner described in paragraph (b)(3) of § 1.72-2, the investment in the contract shall be considered to be equal to the expected return under such contract and the resulting exclusion ratio (100%) shall be applied to all amounts received as an annuity under such contract. For any taxable year, payments received under such a contract shall be considered to be amounts received as an annuity only to the extent that they do not exceed the portion of the investment in the contract which is properly allocable to that year and hence excludable from gross income as a return of premiums or other consideration paid for the contract. The portion of the investment in the contract which is properly allocable to any taxable year shall be determined by dividing the investment in the contract (adjusted for any refund feature in the manner described in paragraph (d) of § 1.72-7) by the applicable multiple (whether for a term certain, life, or lives) which would otherwise be used in determining the expected return for such a contract under § 1.72-5. The multiple shall be adjusted in accordance with the provisions of the table in paragraph (a)(2) of § 1.72-5, if any adjustment is necessary, before making the above computation. If payments are to be made more frequently than annually and the number of payments to be made in the taxable year in which the annuity begins are less than the number of payments to be made each year thereafter, the amounts considered received as an annuity (as otherwise determined under this subdivision) shall not exceed, for such taxable year (including a short taxable year), an amount which bears the same ratio to the portion of the investment in the contract considered allocable to each taxable year as the number of payments to be made in the first year bears to the number of payments to be made in each succeeding year. Thus, if payments are to be made monthly, only seven payments will be made in the first taxable year, and the portion of the investment in the contract allocable to a full year of

payments is $600, the amounts considered received as an annuity in the first taxable year cannot exceed $350 ($600 × 7/12). See subdivision (iii) of this subparagraph for an example illustrating the determination of the portion of the investment in the contract allocable to one taxable year of the taxpayer.

(ii) If subdivision (i) of this subparagraph applies to amounts received by a taxpayer and the total amount of payments he receives in a taxable year is less than the total amount excludable for such year under subdivision (i) of this subparagraph, the taxpayer may elect, in a succeeding taxable year in which he receives another payment, to redetermine the amounts to be received as an annuity during the current and succeeding taxable years. This shall be computed in accordance with the provisions of subdivision (i) of this subparagraph except that:

(*a*) The difference between the portion of the investment in the contract allocable to a taxable year, as found in accordance with subdivision (i) of this subparagraph, and the total payments actually received in the taxable year prior to the election shall be divided by the life expectancy of the annuitant (or annuitants), found in accordance with the appropriate table in § 1.72-9 (and adjusted in accordance with paragraph (a)(2) of § 1.72-5), or by the remaining term of a term certain annuity, computed as of the first day of the first period for which an amount is received as an annuity in the taxable year of the election; and

(*b*) The amount determined under (*a*) of this subdivision shall be added to the portion of the investment in the contract allocable to each taxable year (as otherwise found). To the extent that the total periodic payments received under the contract in the taxable year of the election or any succeeding taxable year does not equal this total sum, such payments shall be excludable from the gross income of the recipient. To the extent such payments exceed the sum so found, they shall be fully includable in recipient's gross income.

See subdivision (iii) of this subparagraph for an example illustrating the redetermination of amounts to be received as an annuity and subdivision (iv) of this subparagraph for the method of making the election provided by this subdivision.

(iii) The application of the principles of this subparagraph may be illustrated by the following example:

Example. Taxpayer A, a 64 year old male, files his return on a calendar year basis and has a life expectancy of 15.6 years on June 30, 1954, the annuity starting date of a contract to which § 1.72-2(b)(3) applies and which he purchased for $20,000. The contract provides for variable annual payments for his life. He receives a payment of $1,000 on June 30, 1955, but receives no other payment until June 30, 1957. He excludes the $1,000 payment from his gross income for the year 1955 since this amount is less than $1,324.50, the amount determined by dividing his investment in the contract ($20,000) by his life expectancy adjusted for annual payments, 15.1 (15.6–0.5), as of the original annuity starting date. Taxpayer A may elect, in his return for the taxable year 1957, to redetermine amounts to be received as an annuity under his contract as of June 30, 1956. For the purpose of determining the extent to which amounts received in 1957 or thereafter shall be considered amounts received as an annuity (to which a 100 percent exclusion ratio shall apply) he shall add $118.63 to the $1,324.50 originally determined to be receivable as an annuity under the contract, making a total of $1,443.13. This is determined by dividing the difference between what was excludable in 1955 and 1956, $2,649 (2×$1,324.50) and what he actually received in those years ($1,000) by his life expectancy adjusted for annual payments, 13.9 (14.4–0.5), as of his age at his nearest birthday (66) on the first day of the first period for which he received an amount as an annuity in the taxable year of election (June 30, 1956). The result, $1,443.13, is excludable in that year and each year thereafter as an amount received as an annuity to which the 100% exclusion ratio applies. It will be noted that in this example the taxpayer received amounts less than the excludable amounts in two successive years and deferred making his election until the third year, and thus was able to accumulate the portion of the investment in the contract allocable to each taxable year to the extent he failed to receive such portion in both years. Assuming that he received $1,500 in the taxable year of his election, he would include $56.87 in his gross income and exclude $1,443.13 therefrom for that year.

(iv) If the taxpayer chooses to make the election described in subdivision (ii) of this subparagraph he shall file

with his return a statement that he elects to make a redetermination of the amounts excludable from gross income under his annuity contract in accordance with the provisions of paragraph (d)(3) of § 1.72-4. This statement shall also contain the following information:

(*a*) The original annuity starting date and his age on that date,

(*b*) The date of the first day of the first period for which he received an amount in the current taxable year,

(*c*) The investment in the contract originally determined (as adjusted for any refund feature), and

(*d*) The aggregate of all amounts received under the contract between the date indicated in (*a*) of this subdivision and the day after the date indicated in (*b*) of this subdivision to the extent such amounts were excludable from gross income.

He shall include in gross income any amounts received during the taxable year for which the return is made in accordance with the redetermination made under this subparagraph.

(e) *Exclusion ratio in the case of two or more annuity elements acquired for a single consideration.* (1)(i) Where two or more annuity elements are provided under a contract described in paragraph (a)(2) of § 1.72-2, an exclusion ratio shall be determined for the contract as a whole and applied to all amounts received as an annuity under any of the annuity elements. To obtain this ratio, the investment in the contract determined in accordance with § 1.72-6 shall be divided by the aggregate of the expected returns found with respect to each of the annuity elements in accordance with § 1.72-5. For this purpose, it is immaterial that payments under one or more of the annuity elements involved have not commenced at the time when an amount is first received as an annuity under one or more of the other annuity elements.

(ii) The exclusion ratio found under subdivision (i) of this subparagraph does not apply to:

(*a*) An annuity element payable to a surviving annuitant under a joint and survivor annuity contract to which section 72(i) and paragraphs (b)(3) and (e)(3) of § 1.72-5 apply, or to

(*b*) A contract under which one or more of the constituent annuity elements provides for payments described in paragraph (b)(3) of § 1.72-2.

For rules with respect to a contract providing for annuity elements described in (*b*) of this subdivision, see subparagraph (2) of this paragraph.

(2) If one or more of the annuity elements under a contract described in paragraph (a)(2) of § 1.72-2 provides for payments to which paragraph (b)(3) of § 1.72-2 applies:

(i) With respect to the annuity elements to which paragraph (b)(3) of § 1.72-2 does not apply, an exclusion ratio shall be determined by dividing the portion of the investment in the entire contract which is properly allocable to all such elements (in the manner provided in paragraph (b)(3)(ii) of § 1.72-6) by the aggregate of the expected returns thereunder and such ratio shall be applied in the manner described in subdivision (i) of subparagraph (1); and

(ii) With respect to the annuity elements to which paragraph (b)(3) of § 1.72-2 does apply, the investment in the entire contract shall be reduced by the portion thereof found in subdivision (i) of this subparagraph and the resulting amount shall be used to determine the extent to which the aggregate of the payments received during the taxable year under all such elements is excludable from gross income. The amount so excludable shall be allocated to each recipient under such elements in the same ratio that the total of the payments he receives each year bears to the total of the payments received by all such recipients during the year. The exclusion ratio with respect to the amounts so allocated shall be 100 percent. See paragraph (f)(2) of § 1.72-5 and paragraph (b)(3) of § 1.72-6.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7043, 35 FR 8477, June 2, 1970; T.D. 7352, 40 FR 16663, Apr. 14, 1975]

§ 1.72-5 Expected return.

(a) *Expected return for but one life.* (1) If a contract to which section 72 applies provides that one annuitant is to receive a fixed monthly income for life, the expected return is determined

by multiplying the total of the annuity payments to be received annually by the multiple shown in Table I of § 1.72-9 under the age (as of annuity starting date) and sex of the measuring life (usually the annuitant's). Thus, where a male purchases a contract providing for an immediate annuity of $100 per month for his life and, as of the annuity starting date (in this case the date of purchase), the annuitant's age at his nearest birthday is 66, the expected return is computed as follows:

Monthly payment of $100 × 12 months equals annual payment of	$1,200
Multiple shown in Table I, male, age 66	14.4
Expected return ($1,200 × 14.0)	17,280

(2) (i) If payments are to be made quarterly, semiannually, or annually, an adjustment of the applicable multiple shown in Table I may be required. A further adjustment may be required where the interval between the annuity starting date and the date of the first payment is less than the interval between future payments. Neither adjustment shall be made, however, if the payments are to be made more frequently than quarterly. The amount of the adjustment, if any, is to be found in accordance with the following table:

If the number of whole months from the annuity starting date to the first payment date is—	0-1	2	3	4	5	6	7	8	9	10	11	12
And payments under the contract are to be made:												
Annually	+0.5	+0.4	+0.3	+0.2	+0.1	0	0	−0.1	−0.2	−0.3	−0.4	−0.5
Semiannually	+.2	+.1	0	0	−.1	−.2						
Quarterly	+.1	0	−.1									

Thus, for a male, age 66, the multiple found in Table I adjusted for quarterly payments the first of which is to be made one full month after the annuity starting date, is 14.5 (14.4+0.1); for semiannual payments the first of which is to be made six full months from the annuity starting date, the adjusted multiple is 14.2 (14.4−0.2); for annual payments the first of which is to be made one full month from the annuity starting date, the adjusted multiple is 14.9 (14.4+0.5). If the annuitant in the example shown in subparagraph (1) of this paragraph were to receive an annual payment of $1,200 commencing 12 full months after his annuity starting date, the amount of the expected return would be $16,680 ($1,200×13.9 [14.4−0.5]).

(ii) Notwithstanding the table in subdivision (i) of this subparagraph, adjustments of multiples for early or other than monthly payments determined prior to February 19, 1956, under the table prescribed in paragraph 1(b)(4) of T.D. 6118 (19 FR 9897, C.B. 1955-1, 699), approved December 30, 1954, need not be redetermined.

(3) If the contract provides for fixed payments to be made to an annuitant until death or until the expiration of a specified limited period, whichever occurs earlier, the expected return of such temporary life annuity is determined by multiplying the total of the annuity payments to be received annually by the multiple shown in Table IV of § 1.72-9 for the age (as of the annuity starting date) and sex of the annuitant and the nearest whole number of years in the specified period. For example, if a male annuitant, age 60 (at his nearest birthday), is to receive $60 per month for five years or until he dies, whichever is earlier, the expected return under such a contract is $3,456, computed as follows:

Monthly payments of $60 × 12 months equals annual payment of	$720
Multiple shown in Table IV for male, age 60, for term of 5 years	4.8
Expected return for 5 year temporary life annuity of $720 per year ($720 × 4.8)	$3,456

The adjustment provided by subparagraph (2) of this paragraph shall not be made with respect to the multiple found in Table IV.

(4) If the contract provides for payments to be made to an annuitant for his lifetime, but the amount of the annual payments is to be decreased after the expiration of a specified limited period, the expected return is computed by considering the contract as a combination of a whole life annuity for the smaller amount plus a temporary life annuity for an amount equal to the difference between the larger and the smaller amount. For example, if a male annuitant, age 60, is to receive $150 per month for five years or until his earlier death, and is to receive $90 per month for the remainder of his lifetime after such five years, the expected return is computed as if the annuitant's contract consisted of a whole life annuity for $90 per month plus a five year temporary life annuity of $60 per month. In such circumstances, the expected return is computed as follows:

Monthly payments of $90 × 12 months equals annual payment of	$1,080
Multiple shown in Table I for male, age 60	18.2
Expected return for whole life annuity of $1,080 per year	$19,656
Expected return for 5-year temporary life annuity of $720 per year (as found in subparagraph (3)) of this paragraph	$3,456
Total expected return	$23,112

If payments are to be made quarterly, semiannually, or annually, an appropriate adjustment of the multiple found in Table I for the whole life annuity should be made in accordance with subparagraph (2) of this paragraph.

(5) If the contract described in subparagraph (4) of this paragraph provided that the amount of the annual payments to the annuitant were to be increased (instead of decreased) after the expiration of a specified limited period, the expected return would be computed as if the annuitant's contract consisted of a whole life annuity for the larger amount minus a temporary life annuity for an amount equal to the difference between the larger and smaller amount. Thus, if the annuitant described in subparagraph (4) of this paragraph were to receive $90 per month for five years or until his earlier death, and to receive $150 per month for the remainder of his lifetime after such five years, the expected return would be computed by subtracting the expected return under a five year temporary life annuity of $60 per month from the expected return under a whole life annuity of $150 per month. In such circumstances, the expected return is computed as follows:

Monthly payments of $150 × 12 months equals annual payment of	$1,800
Multiple shown in Table I (male, age 60)	18.2
Expected return for annuity for whole life of $1,800 per year	$32,760
Less expected return for 5-year temporary life annuity of $720 per year (as found in subparagraph (3))	$3,456
Net expected return	$29,304

If payments are to be made quarterly, semiannually, or annually, an appropriate adjustment of the multiple found in Table I for the whole life annuity should be made in accordance with subparagraph (2) of this paragraph.

(b) *Expected return under joint and survivor and joint annuities.* (1) In the case of a joint and survivor annuity contract involving two annuitants which provides the first annuitant with a fixed monthly income for life and, after the death of the first annuitant, provides an identical monthly income for life to a second annuitant, the expected return shall be determined by multiplying the total amount of the payments to be received annually by the mlutiple obtained from Table II of § 1.72-9 under the ages (as of the annuity starting date) and sexes of the living annuitants. For example, a husband purchases a joint and survivor annuity contract providing for payments of $100 per month for life, and after his death, for the same amount to his wife for the remainder of her life. As of the annuity starting date his age at his nearest birthday is 70 and that of his wife at her nearest birthday is 67. The expected return is computed as follows:

Monthly payments of $100 × 12 months equals annual payment of	$1,200
Multiple shown in Table II (male, age 70; female, age 67)	19.7
Expected return ($1,200 × 19.7)	$23,640

If payments are to be made quarterly, semiannually, or annually, an appropriate adjustment of the multiple found in Table II should be made in accordance with paragraph (a)(2) of this section.

(2) If a contract of the type described in subparagraph (1) of this paragraph provides that a different (rather than an identical) monthly income is payable to the second annuitant, the expected return is computed in the following manner. The applicable multiple in Table II is first found as in the example in subparagraph (1) of this paragraph. The multiple applicable to the first annuitant is then found in Table I as though the contract were for a single life annuity. The multiple from Table I is then subtracted from the multiple obtained from Table II and the resulting multiple is applied to the total payments to be received annually under the contract by the second annuitant. The result is the expected return with respect to the second annuitant. The portion of the expected return with respect to payments to be made during the first annuitant's life is then computed by applying the multiple found in Table I to the total annual payments to be received by such annuitant under the contract. The expected returns with respect to each of the annuitants separately are then aggregated to obtain the expected return under the entire contract.

Example. A husband purchases a joint and survivor annuity providing for payments of $100 per month for his life and, after his death, payments to his wife of $50 per month for her life. As of the annuity starting date his age at his nearest birthday is 70 and that of his wife at her nearest birthday is 67.

Multiple from Table II (male, age 70; female, age 67)	19.7
Multiple from Table I (male, age 70)	12.1
Difference (multiple applicable to second annuitant)	7.6
Portion of expected return, second annuitant ($600 × 7.6)	$4,560
Portion of expected return, first annuitant ($1,200 × 12.1)	$14,520
Expected return under the contract	$19,080

The expected return thus found, $19,080, is to be used in computing the amount to be excluded from gross income. Thus, if the investment in the contract in this example is $14,310, the exclusion ratio is $14,310 ÷ $19,080; or 75 percent. The amount excludable from each monthly payment made to the husband is 75 percent of $100, or $75, and the remaining $25 of each payment received by him shall be included in his gross income. After the husband's death, the amount excludable by the second annuitant (the surviving wife) would be 75 percent of each monthly payment of $50, or $37.50, and the remaining $12.50 of each payment shall be included in her gross income.

The same method is used if the payments are to be increased after the death of the first annuitant. Thus, if the payments to be made until the husband's death were $50 per month and his widow were to receive $100 per month thereafter until her death, the 7.6 multiple in the above example would be applied to the $100 payments, yielding an expected return with respect to this portion of the annuity contract of $9,120 ($1,200 × 7.6). An expected return of $7,260 ($600 × 12.1) would be obtained with respect to the payments to be made the husband, yielding a total expected return under the contract of $16,380 ($9,120 plus $7,260). If payments are to be made quarterly, semiannually, or annually, an appropriate adjustment of the multiples found in Tables I and II should be made in accordance with paragraph (a)(2) of this section.

(3) In the case of a joint and survivor annuity contract in respect of which the first annuitant died in 1951, 1952, or 1953, and the basis of the surviving annuitant's interest in the contract was determinable under section 113(a)(5) of the Internal Revenue Code of 1939, such basis shall be considered the "aggregate of premiums or other consideration paid" by the surviving annuitant for the contract. (For rules governing this determination, see 26 CFR (1939) 39.22(b)(2)-2 and 39.113(a)(5)-1 (Regulations 118).) In determining such an annuitant's investment in the contract, such aggre-

gate shall be reduced by any amounts received under the contract by the surviving annuitant before the annuity starting date, to the extent such amounts were excludable from his gross income at the time of receipt. The expected return of the surviving annuitant in such cases shall be determined in the manner prescribed in paragraph (a) of this section, as though the surviving annuitant alone were involved. For this purpose, the appropriate multiple for the survivor shall be obtained from Table I as of the annuity starting date determined in accordance with paragraph (b)(2)(i) of § 1.72-4.

(4) If a contract involving two annuitants provides for fixed monthly payments to be made as a joint life annuity until the death of the first annuitant to die (in other words, only as long as both remain alive), the expected return under such contract shall be determined by multiplying the total of the annuity payments to be received annually under the contract by the multiple obtained from Table IIA of § 1.72-9 under the ages (as of the annuity starting date) and sexes of the annuitants. If, however, payments are to be made under the contract quarterly, semiannually, or annually, an appropriate adjustment of the multiple found in Table IIA shall be made in accordance with paragraph (a)(2) of this section.

(5) If a joint and survivor annuity contract involving two annuitants provides that a specified amount shall be paid during their joint lives and a different specified amount shall be paid to the survivor upon the death of whichever of the annuitants is the first to die, the following preliminary computation shall be made in all cases preparatory to determining the expected return under the contract:

(i) From Table II, obtain the multiple under both of the annuitants' ages (as of the annuity starting date) and their appropriate sexes;

(ii) From Table IIA, obtain the multiple applicable to both annuitants' ages (as of the annuity starting date) and their appropriate sexes;

(iii) Apply the multiple found in subdivision (i) of this subparagraph to the total of the amounts to be received annually after the death of the first to die; and

(iv) Apply the multiple found in subdivision (ii) of this subparagraph to the difference between the total of the amounts to be received annually before and the total of the amounts to be received annually after the death of the first to die.

If the original annual payment is in excess of the annual payment to be made after the death of the first to die, the expected return is the sum of the amounts determined under subdivisions (iii) and (iv) of this subparagraph. This may be illustrated by the following example:

Example. A husband purchases a joint and survivor annuity providing for payments of $100 a month for as long as both he and his wife live, and, after the death of the first to die, payments to the survivor of $75 a month for life. As of the annuity starting date, his age at his nearest birthday is 70 and that of his wife at her nearest birthday is 67. The expected return under the contract is computed as follows:

Multiple from Table II (male, age 70; female, age 67)	19.7
Multiple from Table IIA (male, age 70; female, age 67)	9.3
Portion of expected return ($900 × 19.7—sum per year after first death)	$17,730
Portion of expected return ($300 × 9.3—amount of change in sum at first death)	$2,790
Expected return under the contract	$20,520

The total expected return in this example, $20,520, is to be used in computing the amount to be excluded from gross income. Thus, if the investment in the contract is $17,887, the exclusion ratio is $17,887 ÷ $20,520, or 87.2 percent. The amount excludable from each monthly payment made while both are alive is 87.2 percent of $100, or $87.20 and the remaining $12.80 of each payment shall be included in gross income. After the death of the first to die, the amount excludable by the survivor shall be 87.2 percent of each monthly payment of $75, or $65.40, and the remaining $9.60 of each payment shall be included in gross income.

If the original annual payment is less than the annual payment to be made after the death of the first to die, the expected return is the difference between the amounts determined under subdivisions (iii) and (iv) of this subparagraph. If, however, payments are

to be made quarterly, semiannually, or annually under the contract, the multiples obtained from both Tables II and IIA shall first be adjusted in a manner prescribed in paragraph (a)(2) of this section.

(6) If a contract provides for the payment of life annuities to two persons during their respective lives and, after the death of one (without regard to which one dies first), provides that the survivor shall receive for life both his own annuity payments and the payments made formerly to the deceased person, the expected return shall be determined in accordance with paragraph (e)(4) of this section.

(7) If paragraph (b)(3) of § 1.72-2 applies to payments provided under a contract and this paragraph applies to such payments, the principles of this paragraph shall be used in making the computations described in paragraph (d)(3) of § 1.72-4. This may be illustrated by the following examples:

Example (1). Taxpayer A, a male age 63, pays $24,000 for a contract which provides that the proceeds (both income and return of capital) from eight units of an investment fund shall be paid monthly to him for his life and that after his death the proceeds from six such units shall be paid monthly to B, a female age 55, for her life, the portion of the investment in the contract allocable to each taxable year of A is $955.20 and that allocable to each taxable year of B is $716.40. This is determined in the following manner:

Multiple from Table II (male, age 63, and female, age 55)	28.1
Number of units to be paid, in effect, as a joint and survivor annuity	×6
Number of total annual unit payments anticipatable with respect to the joint and survivor annuity element	168.6
Multiple from Table I (male, age 63)	16.2
Number of units to be paid in effect, as a single life annuity	×2
Number of total annual unit payments anticipatable with respect to A alone	32.4
Total number of unit payments anticipatable	201
Portion of investment in the contract allocable to unit payments ($24,000 ÷ 201) on an annual basis	$119.40
Number of units payable to A while he continues to live	×8
Portion of the investment in the contract allocable to each taxable year of A	$955.20
Portion of investment in the contract allocable to unit payments ($24,000 ÷ 201) on an annual basis	$119.40
Number of units payable to B for her life after A's death	×6
Portion of the investment in the contract allocable to each taxable year of B	$716.40

For the purpose of the above computation it is immaterial whether or not A lives to or beyond the life expectancy shown for him in Table I.

Example (2). Assume that Taxpayer A in example (1) receives payments for five years which are at least as large as the portion of the investment in the contract allocable to such years, but in the sixth year he receives a total on only $626.40 rather than the $955.20 allocable to such year. A is 69 and B is 61 at the beginning of the first monthly period for which an amount is payable in the seventh taxable year. A makes the election in that year provided under paragraph (d)(3) of § 1.72-4. The difference between the portion of the investment in the contract allocable to the sixth year and the amount actually received in that year is $328.80 ($955.20 less $626.40). In this case, 139.2 unit payments are anticipatable (on an annual basis), since the appropriate multiple from Table II of § 1.72-9, 23.2, multiplied by the number of units payable, in effect, as a joint and survivor annuity yields this result (6×23.2). A's appropriate multiple from Table I of § 1.72-9 for the two units which will cease to be paid at his death is 12.6, and the total number of unit payments anticipatable (on an annual basis) is, therefore, 164.4 (2×12.6 plus 139.2). Dividing the difference previously found ($328.80) by the total number of unit payments thus determined (164.4) indicates that A will have an additional allocation of the investment in the contract of $16 to the seventh and every succeeding full taxable year (8 units×$2), and B will have an additional allocation of the investment in the contract of $12 (6 units×$2) to each taxable year in which she receives 12 monthly payments subsequent to the death of A. The total allocable to each taxable year of A is, therefore, $971.20, and that allocable to each taxable year of B will be $728.40.

Example (3). If, in example (2), A had died at the end of the fifth year, in the sixth year B would have received a payment of $469.80 (that portion of the $626.40 that A would have received which is in the same ratio that 6 units bear to 8 units) and would thus have received $246.60 less than the portion of the investment in the contract originally determined to be allocable to each of her taxable years. In these circumstances, B would be entitled to elect to redetermine the portion of the investment in the contract allocable to the taxable year of

election and all subsequent years. The new amount allocable thereto would be found by dividing the $246.60 difference by her life expectancy as of the first day of the first period for which she received an amount as an annuity in the seventh year of the annuity contract, and adding the result to her originally determined allocation of $716.40.

(c) *Expected return for term certain.* In the case of a contract providing for specific periodic payments which are to be paid for a term certain such as a fixed number of months or years, without regard to life expectancy, the expected return is determined by multiplying the fixed number of years or months for which payments are to be made on or after the annuity starting date by the amount of the payment provided in the contract for each such period.

(d) *Expected return with respect to amount certain.* In the case of contracts involving no life or lives as a measurement of their duration, but under which a determinable total amount is to be paid in installments of lesser amounts paid at periodic intervals, the expected return shall be the total amount guaranteed. If an amount is to be paid periodically until a fund plus interest at a fixed rate is exhausted, but further payments may be made thereafter because of earnings at a higher interest rate, this paragraph shall apply to the total amount anticipatable as a result of the amount of the fund plus the fixed interest thereon. Any amount which may be paid as the result of earnings at a greater interest rate shall be disregarded in determining the expected return. If such an amount is later received, it shall be considered an amount not received as an annuity after the annuity starting date. See paragraph (b)(2) of § 1.72-11.

(e) *Expected return where two or more annuity elements providing for fixed payments are acquired for a single consideration.* (1) In the case of a contract described in paragraph (a)(2) of § 1.72-2, which provides for specified payments to be made under two or more annuity elements, the expected return shall be found for the contract as a whole by aggregating the expected returns found with respect to each annuity element. If individual life annuity elements are involved (including joint and survivor annuities where the primary annuitant died before January 1, 1954) expected return for each of them shall be determined in the manner prescribed in paragraph (a) of this section. If joint and survivor annuity elements are involved, the expected return for such elements shall be determined under the appropriate subparagraph of paragraph (b) of this section. If terms certain or amounts certain are involved, the expected returns for such elements shall be determined under paragraph (c) or (d) of this section, respectively.

(2) The aggregate expected return found in accordance with the rules set forth in subparagraph (1) of this paragraph shall constitute the expected return for the contract as a whole. The investment in the contract shall be divided by the amount thus determined to obtain the exclusion ratio for the contract as a whole. This exclusion ratio shall be applied to all amounts received as an annuity under the contract by any recipient (in accordance with the provisions of § 1.72-4), except in the case of amounts received by a surviving annuitant under a joint and survivor annuity element to which the provisions of section 72(i) and paragraph (b)(3) of this section would apply if it were a separate contract. See subparagraph (3) of this paragraph.

(3) In the case of a contract providing two or more annuity elements, one of which is a joint and survivor annuity element of the type described in section 72(i) and paragraph (b)(3) of this section, the general exclusion ratio for the contract as a whole, for the purpose of computations with respect to all the other annuity elements, shall be determined in accordance with the principles of subparagraphs (1) and (2) of this paragraph. A special exclusion ratio shall thereafter be determined for the surviving annuitant receiving payments under the annuity element described in section 72(i) and paragraph (b)(3) of this section by using the investment in the contract and the expected return determined in accordance with the provisions of paragraph (b)(3) of this section.

(4) In the case of a contract providing for payments to be made to two persons in the manner described in paragraph (b)(6) of § 1.72-5, the expected return is to be computed as though there were two joint and survivor annuities under the same contract, in the following manner. First, the multiple appropriate to the ages (as of the annuity starting date) and sexes of the annuitants involved shall be found in Table II of § 1.72-9 and adjusted, if necessary, in the manner described in paragraph (a)(2) of this section. Second, the multiple so found shall be applied to the sum of the payments to be made each year to both annuitants. The result is the expected return for the contract as a whole.

(5) For rules relating to expected return where two or more annuity elements are acquired for a single consideration and one or more of such elements does not specify a fixed payment for each period, see paragraph (f) of this section.

(f) *Expected return with respect to obligations providing for payments described in paragraph (b)(3) of § 1.72-2.* (1) If a contract to which section 72 applies provides only for payments to be made in a manner described in paragraph (b)(3) of § 1.72-2, the expected return for such contract as a whole shall be an amount equal to the investment in the contract found in accordance with section 72(c)(1) and § 1.72-6, as adjusted for any refund feature in accordance with § 1.72-7.

(2) If a contract to which section 72 applies provides for annuity elements, one or more of which (but not all) provide for payments to be made in a manner described in paragraph (b)(3) of § 1.72-2:

(i) With respect to the portion of the contract providing for annuity elements to which paragraph (b)(3) of § 1.72-2 does not apply, the expected return shall be the aggregate of the expected returns found for each of such elements in accordance with the appropriate paragraph of this section; and

(ii) With respect to all annuity elements to which paragraph (b)(3) of § 1.72-2 does apply, the expected return for all such elements shall be an amount equal to the portion of the investment in the contract allocable to such elements in accordance with the provisions of paragraph (e)(2)(ii) of § 1.72-4 and paragraph (b)(3)(ii)(*b*) of § 1.72-6.

§ 1.72-6 Investment in the contract.

(a) *General rule.* (1) For the purpose of computing the "investment in the contract", it is first necessary to determine the "aggregate amount of premiums or other consideration paid" for such contract. See section 72(c)(1). This determination is made as of the later of the annuity starting date of the contract or the date on which an amount is first received thereunder as an annuity. The amount so found is then reduced by the sum of the following amounts in order to find the investment in the contract:

(i) The total amount of any return of premiums or dividends received (including unrepaid loans or dividends applied against the principal or interest on such loans) on or before the date on which the foregoing determination is made, and

(ii) The total of any other amounts received with respect to the contract on or before such date which were excludable from the gross income of the recipient under the income tax law applicable at the time of receipt.

Amounts to which subdivision (ii) of this subparagraph applies shall include, for example, amounts considered to be return of premiums or other consideration paid under section 22(b)(2) of the Internal Revenue Code of 1939 and amounts considered to be an employer-provided death benefit under section 22(b)(1)(B) of such Code. For rules relating to the extent to which an employee or his beneficiary may include employer contributions in the aggregate amount of premiums or other consideration paid, see § 1.72-8. If the aggregate amount of premiums or other consideration paid for the contract includes amounts for which deductions were allowed under section 404 as contributions on behalf of a self-employed individual, such amounts shall not be included in the investment in the contract.

(2) For the purpose of subparagraph (1) of this paragraph, amounts re-

ceived subsequent to the receipt of an amount as an annuity or subsequent to the annuity starting date, whichever is the later, shall be disregarded. See, however, § 1.72-11.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). In 1950, B purchased an annuity contract for $10,000 which was to provide him with an annuity of $1,000 per year for life. He received $1,000 in each of the years 1950, 1951, 1952, and 1953, prior to the annuity starting date (January 1, 1954). Under the Internal Revenue Code of 1939, $300 of each of these payments (3 percent of $10,000) was includible in his gross income, and the remaining $700 was excludable therefrom during each of the taxable years mentioned. In computing B's investment in the contract as of January 1, 1954, the total amount excludable from his gross income during the years 1950 through 1953 ($2,800) must be subtracted from the consideration paid ($10,000). Accordingly, B's investment in the contract as of January 1, 1954, is $7,200 ($10,000 less $2,800).

Example (2). In 1945, C contracted for an annuity to be paid to him beginning December 31, 1960. In 1945 and in each successive year until 1960, he paid a premium of $5,000. Assuming he receives no payments of any kind under the contract until the date on which he receives the first annual payment as an annuity (December 31, 1960), his investment in the contract as of the annuity starting date (December 31, 1959) will be $75,000 ($5,000 paid each year for the 15 years from 1945 to 1959, inclusive).

Example (3). Assume the same facts as in example (2), except that prior to the annuity starting date C has already received from the insurer dividends of $1,000 each in 1949, 1954, and 1959, such dividends not being includible in his gross income in any of those years. C's investment in the contract, as of the annuity starting date, will then be $72,000 ($75,000-$3,000).

(b) *Allocation of the investment in the contract where two or more annuity elements are acquired for a single consideration.* (1) In the case of a contract described in § 1.72-2(a)(2) which provides for two or more annuity elements, the investment in the contract determined under paragraph (a) shall be allocated to each of the annuity elements in the ratio that the expected return under each annuity element bears to the aggregate of the expected returns under all the annuity elements. The exclusion ratio for the contract as a whole shall be determined by dividing the investment in the contract (after adjustment for the present value of any or all refund features) by the aggregate of the expected returns under all the annuity elements. Thus, if a contract provides for annuity payments of $1,000 per year for life (with no refund feature) to both A and B, a male and female, respectively, each 70 years of age as of the annuity starting date, and such contract is acquired for consideration of $19,575 (without regard to whether paid by A, B, or both), the investment in the contract shall be allocated by determining the exclusion ratio for the contract as a whole in the following manner:

Expectancy of A under Table I and § 1.72-5(a)(2), 11.6 (12.1—0.5), multiplied by $1,000	$11,600
Expectancy of B computed in a similar manner ($1,000 × 14.5 [15.0 − 0.5])	14,500
Total expected return	26,100

The exclusion ratio for both A and B is then $19,575 ÷ $26,100, or 75 percent. A and B shall each exclude from gross income three-fourths ($750) of each $1,000 annual payment received and shall include the remaining one-fourth ($250) of each $1,000 annual payment received in gross income.

(2) In the case of a contract providing for specified annual annuity payments to be made to two persons during their joint lives and the payment of the aggregate of the two individual payments to the survivor for his life, the investment in the contract shall be allocated in accordance with the provisions of subparagraph (1) of this paragraph. For this purpose, the investment in the contract (without regard to the fact that differing amounts may have been contributed by the two annuitants) shall be divided by the expected return determined in accordance with paragraph (e)(4) of § 1.72-5. The resulting exclusion ratio shall then be applied to any amounts received as an annuity by either annuitant.

(3) In the case of a contract providing two or more annuity elements, one or more of which provides for payments to be made in a manner described in paragraph (b)(3) of § 1.72-2, the investment in the contract shall be

allocated to the various annuity elements in the following manner:

(i) If all the annuity elements provide for payments to be made in the manner described in paragraph (b)(3) of § 1.72-2, the investment in the contract shall be allocated on the basis of the amounts received by each recipient by apportioning the amount determined to be excludable under that section to each recipient in the same ratio as the total of the amounts received by him in this taxable year bears to the total of the amounts received by all recipients during the same period; and

(ii) If one or more, but not all, of the annuity elements provide for payments to be made in a manner described in paragraph (b)(3) of § 1.72-2:

(*a*) With respect to all annuity elements to which that section does not apply, the investment in the contract for all such elements shall be the portion of the investment in the contract as a whole (found in accordance with the provisions of this section) which is properly allocable to all such elements; and

(*b*) With respect to all annuity elements to which paragraph (b)(3) of § 1.72-2 does apply, the investment in the contract for all such elements shall be the investment in the contract as a whole (found in accordance with the provisions of this section) as reduced by the portion thereof determined under (*a*) of this subdivision.

For the purpose of determining, pursuant to (*a*) of this subdivision, the portion of the investment in the contract as a whole properly allocable to a particular annuity element, reference shall be made to the present value of such annuity element determined in accordance with paragraph (e)(1)(iii) (*b*) of § 1.101-2.

(c) *Special rules.* (1) For the special rule for determining the investment in the contract for a surviving annuitant in cases where the prior annuitant of a joint and survivor annuity contract died in 1951, 1952, or 1953, see paragraph (b)(3) of § 1.72-5.

(2) For special rules relating to the determination of the investment in the contract where employer contributions are involved, see § 1.72-8. See also paragraph (b) of § 1.72-16 for a special rule relating to the determination of the premiums or other consideration paid for a contract where an employee is taxable on the premiums paid for life insurance protection that is purchased by and considered to be a distribution from an exempt employees' trust.

(3) For the determination of an adjustment in investment in the contract in cases where a contract contains a refund feature, see § 1.72-7.

(4) In the case of "face-amount certificates" described in section 72(1), the amount of consideration paid for purposes of computing the investment in the contract shall include any amount added to the holder's basis by reason of section 1232(a)(3)(E) (relating to basis adjustment for amount of original issue discount ratably included in gross income as interest under section 1232(a)(3)).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10134, Sept. 17, 1963; T.D. 7311, 39 FR 11880, Apr. 1, 1974]

§ 1.72-7 Adjustment in investment where a contract contains a refund feature.

(a) *Definition of a contract containing a refund feature.* A contract to which section 72 applies, contains a refund feature if:

(1) The total amount receivable as an annuity under such contract depends, in whole or in part, on the continuing life of one or more persons,

(2) The contract provides for payments to be made to a beneficiary or the estate of an annuitant on or after the death of the annuitant if a specified amount or a stated number of payments has not been paid to the annuitant or annuitants prior to death, and

(3) Such payments are in the nature of a refund of the consideration paid. See paragraph (c)(1) of § 1.72-11.

(b) *Adjustment of investment for the refund feature in the case of a single life annuity.* Where a single life annuity contract to which section 72 applies contains a refund feature and the special rule of paragraph (d) of this section does not apply, the investment in the contract shall be adjusted in the following manner:

(1) Determine the number of years necessary for the guaranteed amount to be fully paid by dividing the maximum amount guaranteed as of the annuity starting date by the amount to be received annually under the contract to the extent such amount reduces the guaranteed amount. The number of years should be stated in terms of the nearest whole year, considering for this purpose a fraction of one-half or more as an additional whole year.

(2) Consult Table III of § 1.72-9 for the appropriate percentage under the whole number of years found in subparagraph (1) of this paragraph and the age (as of the annuity starting date) and sex of the annuitant.

(3) Multiply the percentage found in subparagraph (2) of this paragraph by whichever of the following is the smaller: (i) The investment in the contract found in accordance with § 1.72-6 or (ii) the total amount guaranteed as of the annuity starting date.

(4) Subtract the amount found in subparagraph (3) of this paragraph from the investment in the contract found in accordance with § 1.72-6.

The resulting amount is the investment in the contract adjusted for the present value of the refund feature without discount for interest and is to be used in determining the exclusion ratio to be applied to the payments received as an annuity. The percentage found in Table III shall not be adjusted in a manner described in paragraph (a)(2) of § 1.72-5. These principles may be illustrated by the following example:

Example. On January 1, 1954, a husband, age 65, purchased for $21,053, an immediate installment refund annuity payable $100 per month for life. The contract provided that in the event the husband did not live long enough to recover the full purchase price, payments were to be made to his wife until the total payments under the contract equaled the purchase price. The investment in the contract adjusted for the purpose of determining the exclusion ratio is computed in the following manner:

Cost of the annuity contract (investment in the contract, unadjusted)		$21,053
Amount to be received annually	$1,200	
Number of years for which payment guaranteed ($21,053 divided by $1,200)	17.5	
Rounded to nearest whole number of years	18	
Percentage located in Table III for age 65 (age of the annuitant as of the annuity starting date) and 18 (the number of whole years) (percent)	30	
Subtract value of the refund feature to the nearest dollar (30 percent of $21,053)		$6,316
Investment in the contract adjusted for the present value of the refund feature without discount for interest		$14,737

If, in the above example, the guaranteed amount had exceeded the investment in the contract, the percentage found in Table III should have been applied to the lesser of these amounts since any excess of the guaranteed amount over the investment in the contract (as found under § 1.72-6) would not have constituted a refund of premiums or other consideration paid. In such a case, however, a different multiple might have been obtained from Table III since the number of years for which payments were guaranteed would have been greater.

(c) *Adjustment of investment for the refund feature in the case of a joint and survivor annuity.* (1) Where a joint and survivor annuity contract described in paragraph (b) (1) or (6) of § 1.72-5 contains a refund feature and the special rule of paragraph (d) of this section does not apply, the investment in the contract shall be adjusted in the following manner:

(i) Determine the number of years necessary for the guaranteed amount to be fully paid by dividing the maximum amount guaranteed as of the annuity starting date by the amount to be received annually under the contract. The number of years should be stated in terms of the nearest whole year, considering for this purpose a fraction of one-half or more as an additional whole year.

(ii) Consult Table III of § 1.72-9 for the appropriate percentages under the whole number of years found in subdivision (i) of this subparagraph and the age (as of the annuity starting date) and sex of each annuitant. If the annuitants are not of the same sex, substitute for the female annuitant a male annuitant 5 years younger, or for the male annuitant a female annuitant 5 years older, so that Table III

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will be entered in both cases with the ages of annuitants of the same sex.

(iii) Find the sum of the two percentages found in accordance with subdivision (ii) of this subparagraph.

(iv) To the age of the elder of the two annuitants (as determined under subdivision (ii) of this subparagraph), add the number of years (indicated in the table below) opposite the number of years by which such annuitants' ages differ:

Number of years difference in age (2 male annuitants or 2 female annuitants)	Addition to older age in years
0 to 1, inclusive	9
2 to 3, inclusive	8
4 to 5, inclusive	7
6 to 8, inclusive	6
9 to 11, inclusive	5
12 to 15, inclusive	4
16 to 20, inclusive	3
21 to 27 inclusive	2
28 to 42, inclusive	1
Over 42	0

(v) Consult Table III for the appropriate percentage under the whole number of years found in subdivision (i) of this subparagraph and the sex and age of the elder annuitant as adjusted under subdivision (iv) of this subparagraph.

(vi) Subtract the percentage obtained in subdivision (v) of this subparagraph from the sum of the percentages found under subdivision (iii)) of this subparagraph. If the result is less than one, subdivisions (vii) and (viii) of this subparagraph shall be disregarded and no adjustment made to the investment in the contract.

(vii) Multiply the percentage found in subdivision (vi) of this subparagraph by whichever of the following is the smaller: (*a*) the investment in the contract found in accordance with § 1.72-6 or (*b*) the total amount guaranteed as of the annuity starting date.

(viii) Subtract the amount found in subdivision (vii) of this subparagraph from the investment in the contract found in accordance with § 1.72-6.

(2) The computation provided in subparagraph (1) of this paragraph for a case to which it applies may be illustrated by the following example:

Example. A husband, age 70, purchases a joint and last survivor annuity for $33,050. The contract provides for payments of $100 a month to be paid first to himself for life and then to B, his 40-year-old daughter, if she survives him. The contract further provides that in the event both die before ten years' payments have been made, payments will be continued to C, a beneficiary, or to C's estate, until ten years' payments have been made. The investment in the contract adjusted for the purpose of determining the exclusion ratio is computed in the following manner:

Cost of the annuity contract (investment in the contract, unadjusted)		$33,050
Guaranteed amount ($1,200 × 10)	$12,000	
Percentage in Table III for male, age 70 (or female, age 75) for duration of the guarantee (10)	21	
Percentage in Table III for female, age 40 (or male, age 35) for duration of the guarantee (10)	2	
Sum of percentages obtained	23	
Difference in years of age between two males, aged 70 and 35 (or 2 females, aged 75 and 40)	35	
Addition, in years, to older age	1	
Percentage in Table III for male one year older than the husband	22	
Difference between percentages obtained (23 percent less 22 percent)	1	
Value of the refund feature to the nearest dollar (1 percent of $12,000)		$120
Investment in the contract adjusted for present value of the refund feature		$32,930

(d) *Adjustment of investment in the contract where paragraph (b)(3) of § 1.72-2 applies to payments.* (1) If paragraph (b)(3) of § 1.72-2 applies to payments to be made under a contract and this section also applies because of the provision for a refund feature, an adjustment shall be made to the investment in the contract in accordance with this paragraph before making the computations required by paragraph (d)(3) of § 1.72-4 and paragraph (b)(7) of § 1.72-5. In the case of the guarantee of a specified amount, the adjustment shall be made by applying the appropriate multiple from Table III, as otherwise determined under this section, to the investment in the contract or the guaranteed amount, whichever is the lesser. The guarantee period shall be found by dividing the amount guaranteed by an amount de-

termined by placing the payments received during the first taxable year (to the extent such payments reduce the guaranteed amount) on an annual basis. Thus, if monthly payments are first received by a taxpayer on a calendar year basis in August, his total payments (to the extent that they reduce the guaranteed amount) for the taxable year would be divided by 5 and multiplied by 12. The guaranteed amount would then be divided by the result of this computation to obtain the guarantee period. If the contract merely guarantees that proceeds from a unit or units of a fund shall be paid for a fixed number of years or the life (or lives) of an annuitant (or annuitants), whichever is the longer, the fixed number of years is the guarantee period. The appropriate percentage in Table III shall be applied to whichever of the following is the smaller: (i) the investment in the contract; or (ii) the product of the payments received in the first taxable year, placed on an annual basis, multiplied by the number of years for which payment of the proceeds of a unit or units is guaranteed.

(2) The principles of this paragraph may be illustrated by the following example:

Example. Taxpayer A, a 50-year-old male, purchases for $25,000, a contract which provides for variable monthly payments to be paid to him for his life. The contract also provides that if he should die before receiving payments for fifteen years, payments shall continue according to the original formula to his estate or beneficiary until payments have been made for that period. Beginning with the month of September, A receives payments which total $450 for the first taxable year of receipt. This amount, placed on an annual basis, is $1,350 ($450 divided by 4, or $112.50; $112.50 multiplied by 12, or $1,350). The guaranteed amount is considered to be $20,250 ($1,350 × 15), and the multiple from Table III (found in the same manner as in paragraph (b) of this section), 9 percent, applied to $20,250 (since this amount is less than the investment in the contract), results in a refund adjustment of $1,822.50. The latter amount, subtracted from the investment in the contract of $25,000, results in an adjusted investment in the contract of $23,177.50. If A dies before receiving payments for 15 years and the remaining payments are made to B, his beneficiary, B shall exclude the entire amount of such payments from his gross income until the amounts so received by B, together with the amounts received by A and excludable from A's gross income, equal or exceed $25,000. Any excess and any payments thereafter received by B shall be fully includible in gross income.

(e) *Adjustment of the investment in the contract where more than one annuity element is provided for a single consideration.* In the case of contracts to which paragraph (b) of § 1.72-6 applies for the purpose of allocating the investment in the contract to two or more annuity elements which are provided for a single consideration, if one or more of such elements involves a refund feature, the portion of the investment in the contract properly allocable to each such element shall be adjusted for the refund feature before aggregating all the investments in order to obtain the exclusion ratio which is to apply to the contract as a whole. For example, if Taxpayer A, an insured 70 years of age, upon maturity of an endowment policy which cost him a net amount of $86,000, elected a dual settlement consisting of (1) monthly payments for his life aggregating $4,146 per year with 10 years' payments certain, and (2) monthly payments for his 60 year old brother, B, aggregating $2,820 per year with 20 years' payments certain, the exclusion ratio to be used by both A and B would be determined in the following manner:

A's expected return (A's payments per year of $4,146 multiplied by his life expectancy from Table I of 12.1)	$50,166.60
B's expected return (B's payments per year of $2,820 multiplied by his life expectancy from Table I of 18.2)	$51,324.00
Sum of expected returns to be used in determining exclusion ratio	$101,490.60
Percentage of total expected return attributable to A's expectancy of life ($50,166.60 ÷ $101,490.60)	49.4
Percentage of total expected return attributable to B's expectancy of life ($51,324 ÷ $101,490.60)	50.6
Portion of investment in the contract allocable to A's annuity (49.4 percent of $86,000)	$42,484.00
Portion of investment in the contract allocable to B's annuity (50.6 percent of $86,000)	$43,516.00
Value of the refund feature with respect to A's annuity (percentage from Table III for male, age 70, and duration 10, or 21 percent, multiplied by lesser of guaranteed amount and allocable portion of investment in the contract, $41,360)	$8,707.00

A's allocable portion of the investment in the contract adjusted for refund feature ($42,484 less $8,707.00)	$33,777.00
Value of the refund feature with respect to B's annuity (percentage from Table III for male, age 60, and duration 20, or 25 percent, multiplied by lesser of guaranteed amount and allocable portion of investment in the contract, $43,516)	$10,879.00
B's allocable portion of the investment in the contract adjusted for refund feature ($43,516 less $10,879.00)	$32,637.00
Sum of A's and B's allocable portions of the investment in the contract after adjustment for the refund feature	$66,414.00
Exclusion ratio for the contract as a whole (total adjusted investment in the contract, $66,414, divided by the total expected return from above, $101,490.60) (percent)	65.4

§ 1.72-8 Effect of certain employer contributions with respect to premiums or other consideration paid or contributed by an employee.

(a) *Contributions in the nature of compensation*—(1) *Amounts includible in gross income of employee under subtitle A of the Code or prior income tax laws.* Section 72(f) provides that for the purposes of section 72 (c), (d), and (e), amounts contributed by an employer for the benefit of an employee or his beneficiaries shall constitute consideration paid or contributed by the employee to the extent that such amounts were includible in the gross income of the employee under subtitle A of the Code or prior income tax laws. Amounts to which this paragraph applies include, for example, contributions made by an employer to or under a trust or plan which fails to qualify under the provisions of section 401(a), provided that the employee's rights to such contributions are nonforfeitable at the time the contributions are made. See sections 402(b) and 403(c) and the regulations thereunder. This subparagraph also applies to premiums paid by an employer (other than premiums paid on behalf of an owner-employee) for life insurance protection for an employee if such premiums are includible in the gross income of the employee when paid. See § 1.72-16. However, such premiums shall only be considered as premiums and other consideration paid by the employee with respect to any benefits attributable to the contract providing the life insurance protection. See § 1.72-16.

(2) *Amounts not includible in gross income of employee at time contributed if paid directly to employee at that time.* Except as provided in subparagraph (3) of this paragraph, section 72(f) provides that for the purposes of section 72 (c), (d), and (e), amounts contributed by an employer for the benefit of an employee or his beneficiaries shall constitute consideration paid or contributed by the employee to the extent that such amounts would not have been includible in the gross income of the employee at the time contributed had they been paid directly to the employee at that time. Amounts to which this subparagraph applies include, for example, contributions made by an employer after December 31, 1950, and before January 1, 1963, if made on account of foreign services rendered by an employee during a period in which the employee qualified as a bona fide resident of a foreign country under section 911(a) of the Internal Revenue Code of 1954, or under section 116(a) of the Internal Revenue Code of 1939. In such a case, it would be immaterial whether such contributions were made under a qualified plan or otherwise. See subparagraph (4) of this paragraph for rules governing the determination of the amount of employer foreign service contributions to which this subparagraph applies. On the other hand, if contributions are made by an employer to a qualified plan at a time when compensation paid directly to the employee concerned with respect to the same services rendered would have been includible in the gross income of the employee, such as in the case of an employee of a State government where contributions are made in 1955 with respect to services rendered by the employee prior to the year 1939, this subparagraph does not apply to such contributions.

(3) *Limitation*—(i) *In general.* Except as provided in subdivision (ii) of this subparagraph, the provisions of subparagraph (2) of this paragraph shall not apply to amounts which were contributed by the employer after December 31, 1962, and which would not have been includible in the gross income of the employee by reason of the application of section 911, if such

amounts had been paid directly to the employee at the time of contribution. Employer contributions attributable to foreign services performed by the employee after December 31, 1962, do not constitute, for purposes of section 72 (c), (d), and (e), consideration paid or contributed by the employee.

(ii) *Exception.* The provisions of subdivision (i) of this subparagraph shall not apply to amounts which were contributed by the employer to provide pension or annuity credits (determined in accordance with the provisions of subparagraph (4) of this paragraph) to the extent such credits are—

(*a*) Attributable to foreign services performed before January 1, 1963, with respect to which the employee qualified for the benefits of section 911(a) (or corresponding provisions of prior revenue laws), and

(*b*) Provided pursuant to pension or annuity plan provisions in existence on March 12, 1962, and on that date applicable to such services.

Amounts described in this subdivision constitute, for purposes of section 72 (c), (d), and (e), consideration paid or contributed by the employee even though such amounts are contributed by the employer after December 31, 1962.

(4) *Determination of employer foreign service contributions which constitute consideration paid or contributed by employee.* For purposes of subparagraphs (2) and (3)(ii) of this paragraph, employer foreign service contributions which constitute, for purposes of section 72 (c), (d), and (e), consideration paid or contributed by the employee shall be determined as follows:

(i) *Treatment of identifiable contributions.* If, under the terms of the pension or annuity plan under which employer contributions were made, such contributions may be identified as—

(*a*) Attributable to foreign services performed before January 1, 1963, with respect to which the employee qualified for the benefits of section 911(a) (or corresponding provisions of prior revenue laws), and

(*b*) Made under pension or annuity plan provisions in existence on March 12, 1962, which were applicable to the services referred to in (*a*) of this subdivision on that date,

the amount of employer contributions so identified shall be considered paid or contributed by the employee.

(ii) *Alternative rule for unidentifiable contributions.* If employer contributions may not be identified in the manner described in subdivision (i) of this subparagraph, the amount of employer contributions attributable to foreign services performed before January 1, 1963, and considered paid or contributed by the employee shall be determined on the basis of an estimated allocation which is reasonable and consistent with the circumstances and the provisions of the pension or annuity plan under which such contributions are made. For example, if an employee's benefits under a pension or annuity plan, which is unchanged after March 12, 1962, are determined with respect to his basic compensation during his entire period of credited service, the amount of employer contributions considered paid or contributed by the employee shall be an amount which bears the same ratio to total employer contributions for such employee under the pension or annuity plan as his basic compensation attributable to foreign services performed before January 1, 1963, with respect to which he qualified for the benefits of section 911(a) (or corresponding provisions of prior revenue laws) bears to his total basic compensation. On the other hand, if an employee's benefits under a pension or annuity plan, which is unchanged after March 12, 1962, are determined with respect to his basic compensation during his final five years of credited service, the amount of employer contributions considered paid or contributed by the employee shall be an amount which bears the same ratio to total employer contributions for such employee as his number of years of credited service before January 1, 1963, with respect to which he qualified for the benefits of section 911(a) (or corresponding provisions of prior revenue laws) bears to his total number of years of credited service.

(5) *Amounts not includible in gross income of employee under subtitle A of*

the Code or prior income tax laws. Amounts contributed by an employer which were not includible in the gross income of the employee under subtitle A of the Code or prior income tax laws, but which would have been includible therein had they been paid directly to the employee, do not constitute consideration paid or contributed by the employee for the purposes of section 72. For example, contributions made by an employer under a qualified employees' trust or plan, which contributions would have been includible in the gross income of the employee had such contributions been paid to him directly as compensation, do not constitute consideration paid or contributed by the employee. Accordingly, the aggregate amount of premiums or other consideration paid or contributed by an employee, insofar as compensatory employer contributions are concerned, consists solely of the (i) sum of all amounts actually contributed by the employee, plus (ii) contributions in the nature of compensation which are deemed to be paid or contributed by the employee under this paragraph.

(b) *Contributions in the nature of death benefits.* In the case of an employee's beneficiary, the aggregate amount of premiums or other consideration paid or deemed to be paid or contributed by the employee shall also include:

(1) Amounts (other than amounts paid as an annuity) to the extent such amounts are excludable from the beneficiary's gross income as a death benefit under section 101(b), and

(2) Any amount or amounts of death benefits which are treated as additional consideration contributed by the employee under section 101(b)(2)(D) and the regulations thereunder, or which were excludable from the beneficiary's gross income as a death benefit under section 22(b)(1)(B) of the Internal Revenue Code of 1939 and the regulations thereunder.

Accordingly, in the case of an employee's beneficiary, any such amount shall be added to any amount or amounts deemed paid or contributed by the employee under paragraph (a)(1) of this section and to any amounts actually contributed by the employee for the purpose of finding the aggregate amount of premiums or other consideration paid or contributed by the employee.

(c) *Amounts "made available" to an employee or his beneficiary.* Any amount which, although not actually paid, is made available to and includable in the gross income of an employee or his beneficiary under the rules of sections 402 and 403 and the regulations thereunder, shall be considered an amount contributed by the employee and shall be aggregated with amounts, if any, to which paragraphs (a) and (b) of this section apply for the purpose of determining the aggregate amount of premiums or other consideration paid by the employee.

(d) *Amounts includable in gross income of employee when his rights under annuity contract change to nonforfeitable rights.* Any amount which, by reason of section 403(d) and after the application of paragraph (b) of § 1.403 (b)-1, is required to be included in an employee's gross income for the year when his rights under an annuity contract change from forfeitable to nonforfeitable rights shall be considered an amount contributed by the employee and shall be aggregated with amounts, if any, to which paragraphs (a), (b), and (c) of this section apply for the purpose of determining the aggregate amount of premiums or other consideration paid or contributed by the employee for such annuity contract. In other words, if, under section 403(d), an employee of an organization exempt from tax under section 501(a) or 521(a) is required to include an amount in gross income by reason of his rights under an annuity contract changing from forfeitable to nonforfeitable rights, such amount, to the extent it is not excludable from gross income under paragraph (b) of § 1.403 (b)-1, shall be considered an amount contributed by such employee for the annuity contract.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6665, 28 FR 7245, July 16, 1963; T.D. 6783, 29 FR 18356, Dec. 24, 1964]

§ 1.72-9 Tables.

The following tables are to be used in connection with computations

under section 72 and the regulations thereunder:

TABLE I.—ORDINARY LIFE ANNUITIES—ONE LIFE—EXPECTED RETURN MULTIPLES

Ages		Multiples
Male	Female	
6	11	65.0
7	12	64.1
8	13	63.2
9	14	62.3
10	15	61.4
11	16	60.4
12	17	59.5
13	18	58.6
14	19	57.7
15	20	56.7
16	21	55.8
17	22	54.9
18	23	53.9
19	24	53.0
20	25	52.1
21	26	51.1
22	27	50.2
23	28	49.3
24	29	48.3
25	30	47.4
26	31	46.5
27	32	45.6
28	33	44.6
29	34	43.7
30	35	42.8
31	36	41.9
32	37	41.0
33	38	40.0
34	39	39.1
35	40	38.2
36	41	37.3
37	42	36.5
38	43	35.6
39	44	34.7
40	45	33.8
41	46	33.0
42	47	32.1
43	48	31.2
44	49	30.4
45	50	29.6
46	51	28.7
47	52	27.9
48	53	27.1
49	54	26.3
50	55	25.5
51	56	24.7
52	57	24.0
53	58	23.2
54	59	22.4
55	60	21.7
56	61	21.0
57	62	20.3

TABLE I.—ORDINARY LIFE ANNUITIES—ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

Ages		Multiples
Male	Female	
58	63	19.6
59	64	18.9
60	65	18.2
61	66	17.5
62	67	16.9
63	68	16.2
64	69	15.6
65	70	15.0
66	71	14.4
67	72	13.8
68	73	13.2
69	74	12.6
70	75	12.1
71	76	11.6
72	77	11.0
73	78	10.5
74	79	10.1
75	80	9.6
76	81	9.1
77	82	8.7
78	83	8.3
79	84	7.8
80	85	7.5
81	86	7.1
82	87	6.7
83	88	6.3
84	89	6.0
85	90	5.7
86	91	5.4
87	92	5.1
88	93	4.8
89	94	4.5
90	95	4.2
91	96	4.0
92	97	3.7
93	98	3.5
94	99	3.3
95	100	3.1
96	101	2.9
97	102	2.7
98	103	2.5
99	104	2.3
100	105	2.1
101	106	1.9
102	107	1.7
103	108	1.5
104	109	1.3
105	110	1.2
106	111	1.0
107	112	.8
108	113	.7
109	114	.6
110	115	.5
111	116	0

TABLE II.—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES

Male	Female	Ages														
		Male 6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
		Female 11	12	13	14	15	16	17	18	19	20	21	22	23	24	25
6	11	73.5	73.0	72.6	72.2	71.8	71.4	71.0	70.7	70.4	70.0	69.7	69.5	69.2	68.9	68.7
7	12	73.0	72.6	72.1	71.7	71.3	70.9	70.5	70.1	69.8	69.4	69.1	68.8	68.5	68.3	68.0
8	13	72.6	72.1	71.6	71.2	70.8	70.4	70.0	69.6	69.2	68.9	68.5	68.2	67.9	67.6	67.3
9	14	72.2	71.7	71.2	70.7	70.3	69.9	69.4	69.0	68.7	68.3	67.9	67.6	67.3	67.0	66.7
10	15	71.8	71.3	70.8	70.3	69.8	69.4	68.9	68.5	68.1	67.7	67.4	67.0	66.7	66.4	66.1
11	16	71.4	70.9	70.4	69.9	69.4	68.9	68.5	68.0	67.6	67.2	66.8	66.5	66.1	65.8	65.4
12	17	71.0	70.5	70.0	69.4	68.9	68.5	68.0	67.5	67.1	66.7	66.3	65.9	65.5	65.2	64.8
13	18	70.7	70.1	69.6	69.0	68.5	68.0	67.5	67.1	66.6	66.2	65.8	65.4	65.0	64.6	64.2
14	19	70.4	69.8	69.2	68.7	68.1	67.6	67.1	66.6	66.1	65.7	65.3	64.8	64.4	64.0	63.7
15	20	70.0	69.4	68.9	68.3	67.7	67.2	66.7	66.2	65.7	65.2	64.8	64.3	63.9	63.5	63.1
16	21	69.7	69.1	68.5	67.9	67.4	66.8	66.3	65.8	65.3	64.8	64.3	63.8	63.4	63.0	62.6
17	22	69.5	68.8	68.2	67.6	67.0	66.5	65.9	65.4	64.8	64.3	63.8	63.4	62.9	62.5	62.0
18	23	69.2	68.5	67.9	67.3	66.7	66.1	65.5	65.0	64.4	63.9	63.4	62.9	62.4	62.0	61.5
19	24	68.9	68.3	67.6	67.0	66.4	65.8	65.2	64.6	64.0	63.5	63.0	62.5	62.0	61.5	61.0
20	25	68.7	68.0	67.3	66.7	66.1	65.4	64.8	64.2	63.7	63.1	62.6	62.0	61.5	61.0	60.6

Male	Female	Ages													
		Male 21	22	23	24	25	26	27	28	29	30	31	32	33	34
		Female 26	27	28	29	30	31	32	33	34	35	36	37	38	39
6	11	68.4	68.2	68.0	67.8	67.6	67.5	67.3	67.1	67.0	66.8	66.7	66.6	66.5	66.4
7	12	67.8	67.5	67.3	67.1	66.9	66.7	66.5	66.4	66.2	66.1	65.9	65.8	65.7	65.6
8	13	67.1	66.8	66.6	66.4	66.2	66.0	65.8	65.6	65.4	65.3	65.1	65.0	64.9	64.7
9	14	66.4	66.2	65.9	65.7	65.4	65.2	65.0	64.8	64.7	64.5	64.3	64.2	64.1	63.9
10	15	65.8	65.5	65.2	65.0	64.7	64.5	64.3	64.1	63.9	63.7	63.6	63.4	63.3	63.1
11	16	65.1	64.8	64.6	64.3	64.1	63.8	63.6	63.4	63.2	63.0	62.8	62.6	62.5	62.3
12	17	64.5	64.2	63.9	63.6	63.4	63.1	62.9	62.7	62.4	62.2	62.0	61.9	61.7	61.5
13	18	63.9	63.6	63.3	63.0	62.7	62.4	62.2	61.9	61.7	61.5	61.3	61.1	60.9	60.8
14	19	63.3	63.0	62.7	62.3	62.0	61.8	61.5	61.2	61.0	60.8	60.6	60.4	60.2	60.0
15	20	62.7	62.4	62.0	61.7	61.4	61.1	60.8	60.6	60.3	60.1	59.8	59.6	59.4	59.2
16	21	62.2	61.8	61.4	61.1	60.8	60.5	60.2	59.9	59.6	59.4	59.1	58.9	58.7	58.5
17	22	61.6	61.2	60.9	60.5	60.2	59.8	59.5	59.2	58.9	58.7	58.4	58.2	57.9	57.7
18	23	61.1	60.7	60.3	59.9	59.6	59.2	58.9	58.6	58.3	58.0	57.7	57.5	57.2	57.0
19	24	60.6	60.2	59.7	59.4	59.0	58.6	58.3	57.9	57.6	57.3	57.0	56.8	56.5	56.3
20	25	60.1	59.6	59.2	58.8	58.4	58.0	57.7	57.3	57.0	56.7	56.4	56.1	55.8	55.6
21	26	59.6	59.1	58.7	58.3	57.9	57.5	57.1	56.7	56.4	56.0	55.7	55.4	55.1	54.9
22	27	59.1	58.7	58.2	57.7	57.3	56.9	56.5	56.1	55.8	55.4	55.1	54.8	54.5	54.2
23	28	58.7	58.2	57.7	57.2	56.8	56.4	55.9	55.5	55.2	54.8	54.4	54.1	53.8	53.5
24	29	58.3	57.7	57.2	56.8	56.3	55.8	55.4	55.0	54.6	54.2	53.8	53.5	53.2	52.8
25	30	57.9	57.3	56.8	56.3	55.8	55.3	54.9	54.4	54.0	53.6	53.2	52.9	52.5	52.2
26	31	57.5	56.9	56.4	55.8	55.3	54.8	54.4	53.9	53.5	53.1	52.7	52.3	51.9	51.6
27	32	57.1	56.5	55.9	55.4	54.9	54.4	53.9	53.4	53.0	52.5	52.1	51.7	51.3	50.9
28	33	56.7	56.1	55.5	55.0	54.4	53.9	53.4	52.9	52.4	52.0	51.6	51.1	50.7	50.3
29	34	56.4	55.8	55.2	54.6	54.0	53.5	53.0	52.4	52.0	51.5	51.0	50.6	50.2	49.3
30	35	56.0	55.4	54.8	54.2	53.6	53.1	52.5	52.0	51.5	51.0	50.5	50.1	49.6	49.2
31	36	55.7	55.1	54.4	53.8	53.2	52.7	52.1	51.6	51.0	50.5	50.0	49.5	49.1	48.7
32	37	55.4	54.8	54.1	53.5	52.9	52.3	51.7	51.1	50.6	50.1	49.5	49.1	48.6	48.1
33	38	55.1	54.5	53.8	53.2	52.5	51.9	51.3	50.7	50.2	49.6	49.1	48.6	48.1	47.6
34	39	54.9	54.2	53.5	52.8	52.2	51.6	50.9	50.3	49.8	49.2	48.7	48.1	47.6	47.1

Table II.—Ordinary Joint Life and Last Survivor Annuities—Two Lives—Expected Return Multiples—Continued

Male	Female	Ages														
		Male 35	36	37	38	39	40	41	42	43	44	45	46	47	48	49
		Female 40	41	42	43	44	45	46	47	48	49	50	51	52	53	54
6	11	66.3	66.2	66.1	66.0	65.9	65.9	65.8	65.7	65.7	65.6	65.6	65.5	65.5	65.5	65.4
7	12	65.4	65.3	65.3	65.2	65.1	65.0	64.9	64.9	64.8	64.8	64.7	64.7	64.6	64.6	64.5
8	13	64.6	64.5	64.4	64.3	64.2	64.2	64.1	64.0	64.0	63.9	63.8	63.8	63.7	63.7	63.7
9	14	63.8	63.7	63.6	63.5	63.4	63.3	63.2	63.2	63.1	63.0	63.0	62.9	62.9	62.8	62.8
10	15	63.0	62.9	62.8	62.7	62.6	62.5	62.4	62.3	62.2	62.2	62.1	62.0	62.0	61.9	61.9
11	16	62.2	62.1	61.9	61.8	61.7	61.6	61.5	61.4	61.4	61.3	61.2	61.2	61.1	61.0	61.0
12	17	61.4	61.3	61.1	61.0	60.9	60.8	60.7	60.6	60.5	60.4	60.4	60.3	60.2	60.2	60.1
13	18	60.6	60.5	60.3	60.2	60.1	60.0	59.9	59.8	59.7	59.6	59.5	59.4	59.4	59.3	59.2
14	19	59.8	59.7	59.5	59.4	59.3	59.1	59.0	58.9	58.8	58.7	58.6	58.6	58.5	58.4	58.4
15	20	59.0	58.9	58.7	58.6	58.4	58.3	58.2	58.1	58.0	57.9	57.8	57.7	57.6	57.6	57.5
16	21	58.3	58.1	57.9	57.8	57.6	57.5	57.4	57.2	57.1	57.0	56.9	56.8	56.8	56.7	56.6
17	22	57.5	57.3	57.2	57.0	56.8	56.7	56.6	56.4	56.3	56.2	56.1	56.0	55.9	55.8	55.7
18	23	56.8	56.6	56.4	56.2	56.0	55.9	55.7	55.6	55.5	55.4	55.2	55.1	55.1	55.0	54.9
19	24	56.0	55.8	55.6	55.4	55.3	55.1	54.9	54.8	54.7	54.5	54.4	54.3	54.2	54.1	54.0
20	25	55.3	55.1	54.9	54.7	54.5	54.3	54.1	54.0	53.8	53.7	53.6	53.5	53.4	53.3	53.2
21	26	54.6	54.4	54.1	53.9	53.7	53.5	53.4	53.2	53.0	52.9	52.8	52.6	52.5	52.4	52.3
22	27	53.9	53.6	53.4	53.2	53.0	52.8	52.6	52.4	52.2	52.1	51.9	51.8	51.7	51.6	51.5
23	28	53.2	52.9	52.7	52.5	52.2	52.0	51.8	51.6	51.5	51.3	51.1	51.0	50.9	50.7	50.6
24	29	52.5	52.3	52.0	51.7	51.5	51.3	51.1	50.9	50.7	50.5	50.3	50.2	50.0	49.9	49.8
25	30	51.9	51.6	51.3	51.0	50.8	50.5	50.3	50.1	49.9	49.7	49.6	49.4	49.2	49.1	49.0
26	31	51.2	50.9	50.6	50.3	50.1	49.8	49.6	49.4	49.2	49.0	48.8	48.6	48.4	48.3	48.1
27	32	50.6	50.3	50.0	49.7	49.4	49.1	48.9	48.6	48.4	48.2	48.0	47.8	47.6	47.5	47.3
28	33	50.0	49.6	49.3	49.0	48.7	48.4	48.2	47.9	47.7	47.5	47.2	47.1	46.9	46.7	46.5
29	34	49.4	49.0	48.7	48.3	48.0	47.7	47.5	47.2	47.0	46.7	46.5	46.3	46.1	45.9	45.7
30	35	48.8	48.4	48.1	47.7	47.4	47.1	46.8	46.5	46.2	46.0	45.8	45.5	45.3	45.2	45.0
31	36	48.2	47.8	47.5	47.1	46.8	46.4	46.1	45.8	45.6	45.3	45.0	44.8	44.6	44.4	44.2
32	37	47.7	47.3	46.9	46.5	46.1	45.8	45.5	45.2	44.9	44.6	44.3	44.1	43.9	43.7	43.4
33	38	47.2	46.7	46.3	45.9	45.5	45.2	44.8	44.5	44.2	43.9	43.7	43.4	43.2	42.9	42.7
34	39	46.7	46.2	45.8	45.4	45.0	44.6	44.2	43.9	43.6	43.3	43.0	42.7	42.5	42.2	42.0

Male	Female	Ages														
		Male 50	51	52	53	54	55	56	57	58	59	60	61	62	63	
		Female 55	56	57	58	59	60	61	62	63	64	65	66	67	68	
6	11	65.4	65.4	65.3	65.3	65.3	65.3	65.3	65.2	65.2	65.2	65.2	65.2	65.2	65.2	
7	12	64.5	64.5	64.4	64.4	64.4	64.4	64.3	64.3	64.3	64.3	64.3	64.3	64.3	64.2	
8	13	63.6	63.6	63.5	63.5	63.5	63.5	63.4	63.4	63.4	63.4	63.4	63.4	63.3	63.3	
9	14	62.7	62.7	62.7	62.6	62.6	62.6	62.5	62.5	62.5	62.5	62.5	62.4	62.4	62.4	
10	15	61.8	61.8	61.8	61.7	61.7	61.7	61.6	61.6	61.6	61.6	61.6	61.5	61.5	61.5	
11	16	61.0	60.9	60.9	60.8	60.8	60.8	60.7	60.7	60.7	60.7	60.6	60.6	60.6	60.6	
12	17	60.1	60.0	60.0	59.9	59.9	59.9	59.8	59.8	59.8	59.8	59.7	59.7	59.7	59.7	
13	18	59.2	59.1	59.1	59.0	59.0	59.0	58.9	58.9	58.9	58.9	58.8	58.8	58.8	58.8	
14	19	58.3	58.2	58.2	58.2	58.1	58.1	58.0	58.0	58.0	57.9	57.9	57.9	57.9	57.9	
15	20	57.4	57.4	57.3	57.3	57.2	57.2	57.1	57.1	57.1	57.0	57.0	57.0	57.0	56.9	
16	21	56.5	56.5	56.4	56.4	56.3	56.3	56.2	56.2	56.2	56.1	56.1	56.1	56.1	56.0	
17	22	55.7	55.6	55.5	55.5	55.4	55.4	55.3	55.3	55.3	55.2	55.2	55.2	55.1	55.1	
18	23	54.8	54.7	54.7	54.6	54.6	54.5	54.5	54.4	54.4	54.3	54.3	54.3	54.2	54.2	
19	24	53.9	53.9	53.8	53.7	53.7	53.6	53.6	53.5	53.5	53.4	53.4	53.4	53.3	53.3	
20	25	53.1	53.0	52.9	52.8	52.8	52.7	52.7	52.6	52.6	52.5	52.5	52.4	52.4	52.4	
21	26	52.2	52.1	52.0	52.0	51.9	51.8	51.8	51.7	51.7	51.6	51.6	51.5	51.5	51.5	
22	27	51.4	51.3	51.2	51.1	51.0	51.0	50.9	50.8	50.8	50.7	50.7	50.6	50.6	50.6	
23	28	50.5	50.4	50.3	50.2	50.2	50.1	50.0	50.0	49.9	49.8	49.8	49.7	49.7	49.7	
24	29	49.7	49.6	49.5	49.4	49.3	49.2	49.1	49.1	49.0	49.0	48.9	48.9	48.8	48.8	
25	30	48.8	48.7	48.6	48.5	48.4	48.3	48.3	48.2	48.1	48.1	48.0	48.0	47.9	47.9	
26	31	48.0	47.9	47.8	47.7	47.6	47.5	47.4	47.3	47.3	47.2	47.1	47.1	47.0	47.0	
27	32	47.2	47.1	46.9	46.8	46.7	46.6	46.5	46.5	46.4	46.3	46.2	46.2	46.1	46.1	
28	33	46.4	46.3	46.1	46.0	45.9	45.8	45.7	45.6	45.5	45.4	45.4	45.3	45.2	45.2	

Table II.—Ordinary Joint Life and Last Survivor Annuities—Two Lives—Expected Return Multiples—Continued

Male	Female	Ages													
		Male 50	51	52	53	54	55	56	57	58	59	60	61	62	63
		Female 55	56	57	58	59	60	61	62	63	64	65	66	67	68
29	34	45.6	45.4	45.3	45.2	45.1	44.9	44.8	44.7	44.7	44.6	44.5	44.4	44.4	44.3
30	35	44.8	44.6	44.5	44.4	44.2	44.1	44.0	43.9	43.8	43.7	43.6	43.6	43.5	43.4
31	36	44.0	43.9	43.7	43.6	43.4	43.3	43.2	43.1	43.0	42.9	42.8	42.7	42.6	42.0
32	37	43.3	43.1	42.9	42.8	42.6	42.5	42.4	42.2	42.1	42.0	41.9	41.9	41.8	41.7
33	38	42.5	42.3	42.1	42.0	41.8	41.7	41.5	41.4	41.3	41.2	41.1	41.0	40.9	40.8
34	39	41.8	41.6	41.4	41.2	41.0	40.9	40.7	40.6	40.5	40.4	40.3	40.2	40.1	40.0

Male	Female	Ages														
		Male 64	65	66	67	68	69	70	71	72	73	74	75	76	77	78
		Female 69	70	71	72	73	74	75	76	77	78	79	80	81	82	83
6	11	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1
7	12	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.1	64.1
8	13	63.3	63.3	63.3	63.3	63.3	63.3	63.3	63.3	63.3	63.2	63.2	63.2	63.2	63.2	63.2
9	14	62.4	62.4	62.4	62.4	62.4	62.4	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3
10	15	61.5	61.5	61.5	61.5	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4
11	16	60.6	60.6	60.6	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5
12	17	59.7	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.5	59.5
13	18	58.8	58.7	58.7	58.7	58.7	58.7	58.7	58.7	58.7	58.7	58.6	58.6	58.6	58.5	58.6
14	19	57.8	57.8	57.8	57.8	57.8	57.8	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7
15	20	56.9	56.9	56.9	56.9	56.9	56.8	56.8	56.8	56.8	56.8	56.8	56.8	56.8	56.8	56.8
16	21	56.0	56.0	56.0	56.0	55.9	55.9	55.9	55.9	55.9	55.9	55.9	55.9	55.9	55.9	55.8
17	22	55.1	55.1	55.1	55.0	55.0	55.0	55.0	55.0	55.0	55.0	55.0	55.0	54.9	54.9	54.9
18	23	54.2	54.2	54.1	54.1	54.1	54.1	54.1	54.1	54.0	54.0	54.0	54.0	54.0	54.0	54.0
19	24	53.3	53.2	53.2	53.2	53.2	53.2	53.2	53.1	53.1	53.1	53.1	53.1	53.1	53.1	53.1
20	25	52.4	52.3	52.3	52.3	52.3	52.2	52.2	52.2	52.2	52.2	52.2	52.2	52.2	52.1	52.1
21	26	51.4	51.4	51.4	51.4	51.3	51.3	51.3	51.3	51.3	51.3	51.3	51.2	51.2	51.2	51.2
22	27	50.5	50.5	50.5	50.5	50.4	50.4	50.4	50.4	50.4	50.3	50.3	50.3	50.3	50.3	50.3
23	28	49.6	49.6	49.6	49.5	49.5	49.5	49.5	49.5	49.4	49.4	49.4	49.4	49.4	49.4	49.4
24	29	48.7	48.7	48.7	48.6	48.6	48.6	48.6	48.5	48.5	48.5	48.5	48.5	48.5	48.4	48.4
25	30	47.8	47.8	47.8	47.7	47.7	47.7	47.6	47.6	47.6	47.6	47.6	47.5	47.5	47.5	47.5
26	31	46.9	46.9	46.8	46.8	46.8	46.8	46.7	46.7	46.7	46.7	46.6	46.6	46.6	46.6	46.6
27	32	46.0	46.0	45.9	45.9	45.9	45.8	45.8	45.8	45.8	45.7	45.7	45.7	45.7	45.7	45.7
28	33	45.1	45.1	45.1	45.0	45.0	44.9	44.9	44.9	44.9	44.8	44.8	44.8	44.8	44.8	44.8
29	34	44.3	44.2	44.2	44.1	44.1	44.0	44.0	44.0	44.0	44.0	43.9	43.9	43.9	43.9	43.8
30	35	43.4	43.3	43.3	43.2	43.2	43.1	43.1	43.1	43.1	43.0	43.0	43.0	43.0	42.9	42.9
31	36	42.5	42.4	42.4	42.3	42.3	42.3	42.2	42.2	42.2	42.1	42.1	42.1	42.1	42.0	42.0
32	37	41.6	41.6	41.5	41.5	41.4	41.4	41.3	41.3	41.3	41.2	41.2	41.2	41.2	41.1	41.1
33	38	40.8	40.7	40.7	40.6	40.5	40.5	40.5	40.4	40.4	40.3	40.3	40.3	40.3	40.2	40.2
34	39	39.9	39.9	39.8	39.7	39.7	39.6	39.6	39.5	39.5	39.5	39.4	39.4	39.4	39.3	39.3

Male	Female	Ages														
		Male 79	80	81	82	83	84	85	86	87	88	89	90	91	92	
		Female 84	85	86	87	88	89	90	91	92	93	94	95	96	97	
6	11	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.0	65.0	65.0	65.0	65.0	
7	12	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	
8	13	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	
9	14	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	
10	15	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	
11	16	60.5	60.5	60.5	60.5	60.5	60.5	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	
12	17	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	

Table II.—Ordinary Joint Life and Last Survivor Annuities—Two Lives—Expected Return Multiples—Continued

Male	Female	Ages													
		Male 79	80	81	82	83	84	85	86	87	88	89	90	91	92
		Female 84	85	86	87	88	89	90	91	92	93	94	95	96	97
13	18	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6
14	19	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7
15	20	56.8	56.8	56.8	56.8	56.8	56.8	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7
16	21	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8
17	22	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9
18	23	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	53.9
19	24	53.1	53.1	53.1	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0
20	25	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1
21	26	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2
22	27	50.3	50.3	50.3	50.3	50.3	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2
23	28	49.4	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3
24	29	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4
25	30	47.5	47.5	47.5	47.5	47.5	47.5	47.5	47.5	47.4	47.4	47.4	47.4	47.4	47.4
26	31	46.6	46.6	46.6	46.6	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5
27	32	45.7	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6
28	33	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7
29	34	43.8	43.8	43.8	43.8	43.8	43.8	43.8	43.8	43.8	43.8	43.7	43.7	43.7	43.7
30	35	42.9	42.9	42.9	42.9	42.9	42.9	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8
31	36	42.0	42.0	42.0	42.0	42.0	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9
32	37	41.1	41.1	41.1	41.1	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0
33	38	40.2	40.2	40.2	40.2	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1
34	39	39.3	39.3	39.3	39.3	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2

Male	Female	Ages															
		Male 93	94	95	96	97	98	99	100	101	102	103	104	105	106	107	108
		Female 98	99	100	101	102	103	104	105	106	107	108	109	110	111	112	113
6	11	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0
7	12	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1
8	13	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2
9	14	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3
10	15	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4
11	16	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4
12	17	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5
13	18	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6
14	19	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7
15	20	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7
16	21	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8
17	22	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9
18	23	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9
19	24	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0
20	25	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1
21	26	51.2	51.2	51.2	51.2	51.2	51.2	51.1	51.1	51.1	51.1	51.1	51.1	51.1	51.1	51.1	51.1
22	27	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2
23	28	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3
24	29	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.3	48.3
25	30	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4
26	31	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5
27	32	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6
28	33	44.7	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6
29	34	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7
30	35	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8
31	36	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9

Table II.—Ordinary Joint Life and Last Survivor Annuities—Two Lives—Expected Return Multiples—Continued

Male	Female	Ages															
		Male 93	94	95	96	97	98	99	100	101	102	103	104	105	106	107	108
		Female 98	99	100	101	102	103	104	105	106	107	108	109	110	111	112	113
32	37	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0
33	38	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.0
34	39	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.1	39.1	39.1	39.1	39.1

Male	Female	Ages												
		Male 35	36	37	38	39	40	41	42	43	44	45	46	47
		Female 40	41	42	43	44	45	46	47	48	49	50	51	52
35	40	46.2	45.7	45.3	44.8	44.4	44.0	43.6	43.3	43.0	42.6	42.3	42.0	41.8
36	41	45.7	45.2	44.8	44.3	43.9	43.5	43.1	42.7	42.3	42.0	41.7	41.4	41.1
37	42	45.3	44.8	44.3	43.8	43.4	42.9	42.5	42.1	41.8	41.4	41.1	40.7	40.4
38	43	44.8	44.3	43.8	43.3	42.9	42.4	42.0	41.6	41.2	40.8	40.5	40.1	39.8
39	44	44.4	43.9	43.4	42.9	42.4	41.9	41.5	41.0	40.6	40.2	39.9	39.5	39.2
40	45	44.0	43.5	42.9	42.4	41.9	41.4	41.0	40.5	40.1	39.7	39.3	38.9	38.6
41	46	43.6	43.1	42.5	42.0	41.5	41.0	40.5	40.0	39.6	39.2	38.8	38.4	38.0
42	47	43.3	42.7	42.1	41.6	41.0	40.5	40.0	39.6	39.1	38.7	38.2	37.8	37.5
43	48	43.0	42.3	41.8	41.2	40.6	40.1	39.6	39.1	38.6	38.2	37.7	37.3	36.9
44	49	42.6	42.0	41.4	40.8	40.2	39.7	39.2	38.7	38.2	37.7	37.2	36.8	36.4
45	50	42.3	41.7	41.1	40.5	39.9	39.3	38.8	38.2	37.7	37.2	36.8	36.3	35.9
46	51	42.0	41.4	40.7	40.1	39.5	38.9	38.4	37.8	37.3	36.8	36.3	35.9	35.4
47	52	41.8	41.1	40.4	39.8	39.2	38.6	38.0	37.5	36.9	36.4	35.9	35.4	35.0

Male	Female	Ages												
		Male 48	49	50	51	52	53	54	55	56	57	58	59	60
		Female 53	54	55	56	57	58	59	60	61	62	63	64	65
35	40	41.5	41.3	41.0	40.8	40.6	40.4	40.3	40.1	40.0	39.8	39.7	39.6	39.5
36	41	40.8	40.6	40.3	40.1	39.9	39.7	39.5	39.3	39.2	39.0	38.9	38.8	38.6
37	42	40.2	39.9	39.6	39.4	39.2	39.0	38.8	38.6	38.4	38.3	38.1	38.0	37.9
38	43	39.5	39.2	39.0	38.7	38.5	38.3	38.1	37.9	37.7	37.5	37.3	37.2	37.1
39	44	38.9	38.6	38.3	38.0	37.8	37.6	37.3	37.1	36.9	36.8	36.6	36.4	36.3
40	45	38.3	38.0	37.7	37.4	37.1	36.9	36.6	36.4	36.2	36.0	35.9	35.7	35.5
41	46	37.7	37.3	37.0	36.7	36.5	36.2	36.0	35.7	35.5	35.3	35.1	35.0	34.8
42	47	37.1	36.8	36.4	36.1	35.8	35.6	35.3	35.1	34.8	34.6	34.4	34.2	34.1
43	48	36.5	36.2	35.8	35.5	35.2	34.9	34.7	34.4	34.2	33.9	33.7	33.5	33.3
44	49	36.0	35.6	35.3	34.9	34.6	34.3	34.0	33.8	33.5	33.3	33.0	32.8	32.6
45	50	35.5	35.1	34.7	34.4	34.0	33.7	33.4	33.1	32.9	32.6	32.4	32.2	31.9
46	51	35.0	34.6	34.2	33.8	33.5	33.1	32.8	32.5	32.2	32.0	31.7	31.5	31.3
47	52	34.5	34.1	33.7	33.3	32.9	32.6	32.2	31.9	31.6	31.4	31.1	30.9	30.6
48	53	34.0	33.6	33.2	32.8	32.4	32.0	31.7	31.4	31.1	30.8	30.5	30.2	30.0
49	54	33.6	33.1	32.7	32.3	31.9	31.5	31.2	30.8	30.5	30.2	29.9	29.6	29.4
50	55	33.2	32.7	32.3	31.8	31.4	31.0	30.6	30.3	29.9	29.6	29.3	29.0	28.8
51	56	32.8	32.3	31.8	31.4	30.9	30.5	30.1	29.8	29.4	29.1	28.8	28.5	28.2
52	57	32.4	31.9	31.4	30.9	30.5	30.1	29.7	29.3	28.9	28.6	28.2	27.9	27.6
53	58	32.0	31.5	31.0	30.5	30.1	29.6	29.2	28.8	28.4	28.1	27.7	27.4	27.1
54	59	31.7	31.2	30.6	30.1	29.7	29.2	28.8	28.3	27.9	27.6	27.2	26.9	26.5
55	60	31.4	30.8	30.3	29.8	29.3	28.8	28.3	27.9	27.5	27.1	26.7	26.4	26.0
56	61	31.1	30.5	29.9	29.4	28.9	28.4	27.9	27.5	27.1	26.7	26.3	25.9	25.5
57	62	30.8	30.2	29.6	29.1	28.6	28.1	27.6	27.1	26.7	26.2	25.8	25.4	25.1
58	63	30.5	29.9	29.3	28.8	28.2	27.7	27.2	26.7	26.3	25.8	25.4	25.0	24.6
59	64	30.2	29.6	29.0	28.5	27.9	27.4	26.9	26.4	25.9	25.4	25.0	24.6	24.2
60	65	30.0	29.4	28.8	28.2	27.6	27.1	26.5	26.0	25.5	25.1	24.6	24.2	23.8

Table II.—Ordinary Joint Life and Last Survivor Annuities—Two Lives—Expected Return Multiples—Continued

Male	Female	Ages												
		Male 61	62	63	64	65	66	67	68	69	70	71	72	73
		Female 66	67	68	69	70	71	72	73	74	75	76	77	78
35	40	39.4	39.3	39.2	39.1	39.0	38.9	38.9	38.8	38.8	38.7	38.7	38.6	38.6
36	41	38.5	38.4	38.3	38.2	38.2	38.1	38.0	38.0	37.9	37.9	37.8	37.8	37.7
37	42	37.7	37.6	37.5	37.4	37.3	37.3	37.2	37.1	37.1	37.0	36.9	36.9	36.9
38	43	36.9	36.8	36.7	36.6	36.5	36.4	36.4	36.3	36.2	36.2	36.1	36.0	36.0
39	44	36.2	36.0	35.9	35.8	35.7	35.6	35.5	35.5	35.4	35.3	35.3	35.2	35.2
40	45	35.4	35.3	35.1	35.0	34.9	34.8	34.7	34.6	34.6	34.5	34.4	34.4	34.3
41	46	34.6	34.5	34.4	34.2	34.1	34.0	33.9	33.8	33.8	33.7	33.6	33.5	33.5
42	47	33.9	33.7	33.6	33.5	33.4	33.2	33.1	33.0	33.0	32.9	32.8	32.7	32.7
43	48	33.2	33.0	32.9	32.7	32.6	32.5	32.4	32.3	32.2	32.1	32.0	31.9	31.9
44	49	32.5	32.3	32.1	32.0	31.8	31.7	31.6	31.5	31.4	31.3	31.2	31.1	31.1
45	50	31.8	31.6	31.4	31.3	31.1	31.0	30.8	30.7	30.6	30.5	30.4	30.4	30.3
46	51	31.1	30.9	30.7	30.5	30.4	30.2	30.1	30.0	29.9	29.8	29.7	29.6	29.5
47	52	30.4	30.2	30.0	29.8	29.7	29.5	29.4	29.3	29.1	29.0	28.9	28.8	28.7
48	53	29.8	29.5	29.3	29.2	29.0	28.8	28.7	28.5	28.4	28.3	28.2	28.1	28.0
49	54	29.1	28.9	28.7	28.5	28.3	28.1	28.0	27.8	27.7	27.6	27.5	27.4	27.3
50	55	28.5	28.3	28.1	27.8	27.6	27.5	27.3	27.1	27.0	26.9	26.7	26.6	26.5
51	56	27.9	27.7	27.4	27.2	27.0	26.8	26.6	26.5	26.3	26.2	26.0	25.9	25.8
52	57	27.3	27.1	26.8	26.6	26.4	26.2	26.0	25.8	25.7	25.5	25.4	25.2	25.1
53	58	26.8	26.5	26.2	26.0	25.8	25.6	25.4	25.2	25.0	24.8	24.7	24.6	24.4
54	59	26.2	25.9	25.7	25.4	25.2	25.0	24.7	24.6	24.4	24.2	24.0	23.9	23.8
55	60	25.7	25.4	25.1	24.9	24.6	24.4	24.1	23.9	23.8	23.6	23.4	23.3	23.1
56	61	25.2	24.9	24.6	24.3	24.1	23.8	23.6	23.4	23.2	23.0	22.8	22.6	22.5
57	62	24.7	24.4	24.1	23.8	23.5	23.3	23.0	22.8	22.6	22.4	22.2	22.0	21.9
58	63	24.3	23.9	23.6	23.3	23.0	22.7	22.5	22.2	22.0	21.8	21.6	21.4	21.3
59	64	23.8	23.5	23.1	22.8	22.5	22.2	21.9	21.7	21.5	21.2	21.0	20.9	20.7
60	65	23.4	23.0	22.7	22.3	22.0	21.7	21.4	21.2	20.9	20.7	20.5	20.3	20.1
61	66	23.0	22.6	22.2	21.9	21.6	21.3	21.0	20.7	20.4	20.2	20.0	19.8	19.6
62	67	22.6	22.2	21.8	21.5	21.1	20.8	20.5	20.2	19.9	19.7	19.5	19.2	19.0
63	68	22.2	21.8	21.4	21.1	20.7	20.4	20.1	19.8	19.5	19.2	19.0	18.7	18.5
64	69	21.9	21.5	21.1	20.7	20.3	20.0	19.6	19.3	19.0	18.7	18.5	18.2	18.0
65	70	21.6	21.1	20.7	20.3	19.9	19.6	19.2	18.9	18.6	18.3	18.0	17.8	17.5
66	71	21.3	20.8	20.4	20.0	19.6	19.2	18.8	18.5	18.2	17.9	17.6	17.3	17.1
67	72	21.0	20.5	20.1	19.6	19.2	18.8	18.5	18.1	17.8	17.5	17.2	16.9	16.7
68	73	20.7	20.2	19.8	19.3	18.9	18.5	18.1	17.8	17.4	17.1	16.8	16.5	16.2
69	74	20.4	19.9	19.5	19.0	18.6	18.2	17.8	17.4	17.1	16.7	16.4	16.1	15.8
70	75	20.2	19.7	19.2	18.7	18.3	17.9	17.5	17.1	16.7	16.4	16.1	15.8	15.5
71	76	20.0	19.5	19.0	18.5	18.0	17.6	17.2	16.8	16.4	16.1	15.7	15.4	15.1
72	77	19.8	19.2	18.7	18.2	17.8	17.3	16.9	16.5	16.1	15.8	15.4	15.1	14.8
73	78	19.6	19.0	18.5	18.0	17.5	17.1	16.7	16.2	15.8	15.5	15.1	14.8	14.4

Male	Female	Ages												
		Male 74	75	76	77	78	79	80	81	82	83	84	85	
		Female 79	80	81	82	83	84	85	86	87	88	89	90	
35	40	38.6	38.5	38.5	38.5	38.4	38.4	38.4	38.4	38.4	38.4	38.3	38.3	
36	41	37.7	37.6	37.6	37.6	37.6	27.5	37.5	37.5	37.5	37.5	37.5	37.4	
37	42	36.8	36.8	36.7	36.7	36.7	36.7	36.6	36.6	36.6	36.6	36.6	36.6	
38	43	36.0	35.9	35.9	35.9	35.8	35.8	35.8	35.8	35.7	35.7	35.7	35.7	
39	44	35.1	35.1	35.0	35.0	35.0	34.9	34.9	34.9	34.9	34.8	34.8	34.8	
40	45	34.3	34.2	34.2	34.1	34.1	34.1	34.1	34.0	34.0	34.0	34.0	34.0	
41	46	33.4	33.4	33.3	33.3	33.3	33.2	33.2	33.2	33.2	33.1	33.1	33.1	
42	47	32.6	32.6	32.5	32.5	32.4	32.4	32.4	32.3	32.3	32.3	32.3	32.3	
43	48	31.8	31.8	31.7	31.7	31.6	31.6	31.5	31.5	31.5	31.5	31.4	31.4	
44	49	31.0	30.9	30.9	30.8	30.8	30.8	30.7	30.7	30.7	30.6	30.6	30.6	

Table II.—Ordinary Joint Life and Last Survivor Annuities—Two Lives—Expected Return Multiples—Continued

Male	Female	Ages											
		Male 74	75	76	77	78	79	80	81	82	83	84	85
		Female 79	80	81	82	83	84	85	86	87	88	89	90
45	50	30.2	30.1	30.1	30.0	30.0	29.9	29.9	29.9	29.8	29.8	29.8	29.8
46	51	29.4	29.4	29.3	29.2	29.2	29.2	29.1	29.1	29.0	29.0	29.0	28.9
47	52	28.7	28.6	28.5	28.5	28.4	28.4	28.3	28.3	28.2	28.2	28.2	28.1
48	53	27.9	27.8	27.8	27.7	27.6	27.6	27.5	27.5	27.5	27.4	27.4	27.4
49	54	27.2	27.1	27.0	26.9	26.9	26.8	26.8	26.7	26.7	26.6	26.6	26.6
50	55	26.4	26.3	26.3	26.2	26.1	26.1	26.0	26.0	25.9	25.9	25.8	25.8
51	56	25.7	25.6	25.5	25.5	25.4	25.3	25.3	25.2	25.2	25.1	25.1	25.0
52	57	25.0	24.9	24.8	24.7	24.7	24.6	24.5	24.5	24.4	24.4	24.3	24.3
53	58	24.3	24.2	24.1	24.0	23.9	23.9	23.8	23.7	23.7	23.6	23.6	23.5
54	59	23.6	23.5	23.4	23.3	23.2	23.2	23.1	23.0	23.0	22.9	22.9	22.8
55	60	23.0	22.9	22.8	22.7	22.6	22.5	22.4	22.3	22.3	22.2	22.2	22.1
56	61	22.3	22.2	22.1	22.0	21.9	21.8	21.7	21.6	21.6	21.5	21.5	21.4
57	62	21.7	21.6	21.5	21.3	21.2	21.1	21.1	21.0	20.9	20.8	20.8	20.7
58	63	21.1	21.0	20.8	20.7	20.6	20.5	20.4	20.3	20.2	20.2	20.1	20.0
59	64	20.5	20.4	20.2	20.1	20.0	19.9	19.8	19.7	19.6	19.5	19.4	19.4
60	65	19.9	19.8	19.6	19.5	19.4	19.3	19.1	19.0	19.0	18.9	18.8	18.7
61	66	19.4	19.2	19.1	18.9	18.8	18.7	18.5	18.4	18.3	18.3	18.2	18.1
62	67	18.8	18.7	18.5	18.3	18.2	18.1	18.0	17.8	17.7	17.7	17.6	17.5
63	68	18.3	18.1	18.0	17.8	17.6	17.5	17.4	17.3	17.2	17.1	17.0	16.9
64	69	17.8	17.6	17.4	17.3	17.1	17.0	16.8	16.7	16.6	16.5	16.4	16.3
65	70	17.3	17.1	16.9	16.7	16.6	16.4	16.3	16.2	16.0	15.9	15.8	15.8
66	71	16.9	16.6	16.4	16.3	16.1	15.9	15.8	15.6	15.5	15.4	15.3	15.2
67	72	16.4	16.2	16.0	15.8	15.6	15.4	15.3	15.1	15.0	14.9	14.8	14.7
68	73	16.0	15.7	15.5	15.3	15.1	15.0	14.8	14.6	14.5	14.4	14.3	14.2
69	74	15.6	15.3	15.1	14.9	14.7	14.5	14.3	14.2	14.0	13.9	13.8	13.7
70	75	15.2	14.9	14.7	14.5	14.3	14.1	13.9	13.7	13.6	13.4	13.3	13.2
71	76	14.8	14.5	14.3	14.1	13.8	13.6	13.5	13.3	13.1	13.0	12.8	12.7
72	77	14.5	14.2	13.9	13.7	13.5	13.2	13.0	12.9	12.7	12.5	12.4	12.3
73	78	14.1	13.8	13.6	13.3	13.1	12.9	12.7	12.5	12.3	12.1	12.0	11.8
74	79	13.8	13.5	13.2	13.0	12.7	12.5	12.3	12.1	11.9	11.7	11.6	11.4
75	80	13.5	13.2	12.9	12.6	12.4	12.2	11.9	11.7	11.5	11.4	11.2	11.0
76	81	13.2	12.9	12.6	12.3	12.1	11.8	11.6	11.4	11.2	11.0	10.8	10.7
77	82	13.0	12.6	12.3	12.1	11.8	11.5	11.3	11.1	10.8	10.7	10.5	10.3
78	83	12.7	12.4	12.1	11.8	11.5	11.2	11.0	10.7	10.5	10.3	10.1	10.0
79	84	12.5	12.2	11.8	11.5	11.2	11.0	10.7	10.5	10.2	10.0	9.8	9.6
80	85	12.3	11.9	11.6	11.3	11.0	10.7	10.4	10.2	10.0	9.7	9.5	9.3
81	86	12.1	11.7	11.4	11.1	10.7	10.5	10.2	9.9	9.7	9.5	9.3	9.1
82	87	11.9	11.5	11.2	10.8	10.5	10.2	10.0	9.7	9.4	9.2	9.0	8.8
83	88	11.7	11.4	11.0	10.7	10.3	10.0	9.7	9.5	9.2	9.0	8.7	8.5
84	89	11.6	11.2	10.8	10.5	10.1	9.8	9.5	9.3	9.0	8.7	8.5	8.3
85	90	11.4	11.0	10.7	10.3	10.0	9.6	9.3	9.1	8.8	8.5	8.3	8.1

Male	Female	Ages											
		Male 86	87	88	89	90	91	92	93	94	95	96	97
		Female 91	92	93	94	95	96	97	98	99	100	101	102
35	40	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3
36	41	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4
37	42	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5
38	43	35.7	35.7	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6
39	44	34.8	34.8	34.8	34.8	34.8	34.8	34.7	34.7	34.7	34.7	34.7	34.7
40	45	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9
41	46	33.1	33.1	33.1	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0

Table II.—Ordinary Joint Life and Last Survivor Annuities—Two Lives—Expected Return Multiples—Continued

Male	Female	Ages											
		Male 86	87	88	89	90	91	92	93	94	95	96	97
		Female 91	92	93	94	95	96	97	98	99	100	101	102
42	47	32.2	32.2	32.2	32.2	32.2	32.2	32.2	32.2	32.2	32.1	32.1	32.1
43	48	31.4	31.4	31.4	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3
44	49	30.6	30.5	30.5	30.5	30.5	30.5	30.5	30.5	30.5	30.5	30.5	30.4
45	50	29.7	29.7	29.7	29.7	29.7	29.7	29.7	29.6	29.6	29.6	29.6	29.6
46	51	28.9	28.9	28.9	28.9	28.9	28.8	28.8	28.8	28.8	28.8	28.8	28.8
47	52	28.1	28.1	28.1	28.1	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0
48	53	27.3	27.3	27.3	27.3	27.2	27.2	27.2	27.2	27.2	27.2	27.2	27.2
49	54	26.5	26.5	26.5	26.5	26.5	26.4	26.4	26.4	26.4	26.4	26.4	26.4
50	55	25.8	25.7	25.7	25.7	25.7	25.7	25.6	25.6	25.6	25.6	25.6	25.6
51	56	25.0	25.0	24.9	24.9	24.9	24.9	24.9	24.9	24.8	24.8	24.8	24.8
52	57	24.3	24.2	24.2	24.2	24.1	24.1	24.1	24.1	24.1	24.1	24.1	24.0
53	58	23.5	23.5	23.4	23.4	23.4	23.4	23.4	23.3	23.3	23.3	23.3	23.3
54	59	22.8	22.7	22.7	22.7	22.7	22.6	22.6	22.6	22.6	22.6	22.6	22.5
55	60	22.1	22.0	22.0	22.0	21.9	21.9	21.9	21.9	21.8	21.8	21.8	21.8
56	61	21.4	21.3	21.3	21.3	21.2	21.2	21.2	21.1	21.1	21.1	21.1	21.1
57	62	20.7	20.6	20.6	20.6	20.5	20.5	20.5	20.4	20.4	20.4	20.4	20.4
58	63	20.0	19.9	19.9	19.9	19.8	19.8	19.8	19.8	19.7	19.7	19.7	19.7
59	64	19.3	19.3	19.2	19.2	19.2	19.1	19.1	19.1	19.0	19.0	19.0	19.0

Male	Female	Ages											
		Male 98	99	100	101	102	103	104	105	106	107	108	
		Female 103	104	105	106	107	108	109	110	111	112	113	
35	40	38.3	38.3	38.3	38.3	38.3	38.3	38.2	38.2	38.2	38.2	38.2	
36	41	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.3	
37	42	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	
38	43	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	
39	44	34.7	34.7	34.7	34.7	34.7	34.7	34.7	34.7	34.7	34.7	34.7	
40	45	33.9	33.8	33.8	33.8	33.8	33.8	33.8	33.8	33.8	33.8	33.8	
41	46	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	
42	47	32.1	32.1	32.1	32.1	32.1	32.1	32.1	32.1	32.1	32.1	32.1	
43	48	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	
44	49	30.4	30.4	30.4	30.4	30.4	30.4	30.4	30.4	30.4	30.4	30.4	
45	50	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	
46	51	28.8	28.8	28.8	28.8	28.8	28.8	28.8	28.8	28.8	28.8	28.7	
47	52	28.0	28.0	28.0	28.0	28.0	28.0	28.0	27.9	27.9	27.9	27.9	
48	53	27.2	27.2	27.2	27.2	27.2	27.1	27.1	27.1	27.1	27.1	27.1	
49	54	26.4	26.4	26.4	26.4	26.4	26.3	26.3	26.3	26.3	26.3	26.3	
50	55	25.6	25.6	25.6	25.6	25.6	25.6	25.6	25.6	25.5	25.5	25.5	
51	56	24.8	24.8	24.8	24.8	24.8	24.8	24.8	24.8	24.8	24.8	24.7	
52	57	24.0	24.0	24.0	24.0	24.0	24.0	24.0	24.0	24.0	24.0	24.0	
53	58	23.3	23.3	23.3	23.3	23.3	23.3	23.2	23.2	23.2	23.2	23.2	
54	59	22.5	22.5	22.5	22.5	22.5	22.5	22.5	22.5	22.5	22.5	22.5	
55	60	21.8	21.8	21.8	21.8	21.8	21.8	21.8	21.8	21.8	21.7	21.7	
56	61	21.1	21.1	21.1	21.1	21.1	21.0	21.0	21.0	21.0	21.0	21.0	
57	62	20.4	20.4	20.4	20.3	20.3	20.3	20.3	20.3	20.3	20.3	20.3	
58	63	19.7	19.7	19.7	19.6	19.6	19.6	19.6	19.6	19.6	19.6	19.6	
59	64	19.0	19.0	19.0	19.0	19.0	18.9	18.9	18.9	18.9	18.9	18.9	

Table II.—Ordinary Joint Life and Last Survivor Annuities—Two Lives—Expected Return Multiples—Continued

Male	Female	Ages											
		Male 86	87	88	89	90	91	92	93	94	95	96	97
		Female 91	92	93	94	95	96	97	98	99	100	101	102
60	65	18.7	18.6	18.6	18.5	18.5	18.5	18.4	18.4	18.4	18.4	18.3	18.3
61	66	18.1	18.0	17.9	17.9	17.9	17.8	17.8	17.8	17.7	17.7	17.7	17.7
62	67	17.4	17.4	17.3	17.3	17.2	17.2	17.1	17.1	17.1	17.1	17.0	17.0
63	68	16.8	16.8	16.7	16.7	16.6	16.6	16.5	16.5	16.5	16.4	16.4	16.4
64	69	16.2	16.2	16.1	16.1	16.0	16.0	15.9	15.9	15.9	15.8	15.8	15.8
65	70	15.7	15.6	15.5	15.5	15.4	15.4	15.3	15.3	15.3	15.2	15.2	15.2
66	71	15.1	15.0	15.0	14.9	14.8	14.8	14.7	14.7	14.7	14.6	14.6	14.6
67	72	14.6	14.5	14.4	14.4	14.3	14.2	14.2	14.1	14.1	14.1	14.1	14.0
68	73	14.1	14.0	13.9	13.8	13.8	13.7	13.6	13.6	13.6	13.5	13.5	13.5
69	74	13.6	13.5	13.4	13.3	13.2	13.2	13.1	13.1	13.0	13.0	13.0	12.9
70	75	13.1	13.0	12.9	12.8	12.7	12.7	12.6	12.5	12.5	12.5	12.4	12.4
71	76	12.6	12.5	12.4	12.3	12.2	12.2	12.1	12.1	12.0	12.0	11.9	11.9
72	77	12.1	12.0	11.9	11.8	11.8	11.7	11.6	11.6	11.5	11.5	11.4	11.4
73	78	11.7	11.6	11.5	11.4	11.3	11.2	11.2	11.1	11.0	11.0	11.0	10.9
74	79	11.3	11.2	11.1	11.0	10.9	10.8	10.7	10.7	10.6	10.6	10.5	10.5
75	80	10.9	10.8	10.7	10.5	10.5	10.4	10.3	10.2	10.2	10.1	10.1	10.0
76	81	10.5	10.4	10.3	10.2	10.1	10.0	9.9	9.8	9.7	9.7	9.7	9.6
77	82	10.2	10.0	9.9	9.8	9.7	9.6	9.5	9.4	9.3	9.3	9.2	9.2
78	83	9.8	9.7	9.5	9.4	9.3	9.2	9.1	9.0	9.0	8.9	8.9	8.8
79	84	9.5	9.3	9.2	9.2	8.9	8.8	8.8	8.7	8.6	8.5	8.5	8.4
80	85	9.2	9.0	8.9	8.7	8.6	8.5	8.4	8.3	8.3	8.2	8.1	8.1
81	86	8.9	8.7	8.6	8.4	8.3	8.2	8.1	8.0	7.9	7.9	7.8	7.7
82	87	8.6	8.4	8.3	8.1	8.0	7.9	7.8	7.7	7.6	7.5	7.5	7.4
83	88	8.3	8.2	8.0	7.9	7.7	7.6	7.5	7.4	7.3	7.2	7.2	7.1
84	89	8.1	7.9	7.8	7.6	7.5	7.3	7.2	7.1	7.0	7.0	6.9	6.8

Male	Female	Ages											
		Male 98	99	100	101	102	103	104	105	106	107	108	
		Female 103	104	105	106	107	108	109	110	111	112	113	
60	65	18.3	18.3	18.3	18.3	18.3	18.3	18.3	18.2	18.2	18.2	18.2	
61	66	17.7	17.7	17.6	17.6	17.6	17.6	17.6	17.6	17.6	17.6	17.5	
62	67	17.0	17.0	17.0	17.0	17.0	17.0	16.9	16.9	16.9	16.9	16.9	
63	68	16.4	16.4	16.4	16.3	16.3	16.3	16.3	16.3	16.3	16.3	16.2	
64	69	15.8	15.8	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.6	
65	70	15.2	15.2	15.1	15.1	15.1	15.1	15.1	15.1	15.1	15.0	15.0	
66	71	14.6	14.6	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.4	14.4	
67	72	14.0	14.0	14.0	14.0	13.9	13.9	13.9	13.9	13.9	13.9	13.8	
68	73	13.5	13.4	13.4	13.4	13.4	13.4	13.3	13.3	13.3	13.3	13.2	
69	74	12.9	12.9	12.9	12.8	12.8	12.8	12.8	12.8	12.8	12.7	12.7	
70	75	12.4	12.4	12.3	12.3	12.3	12.3	12.3	12.2	12.2	12.2	12.1	
71	76	11.9	11.9	11.8	11.8	11.8	11.8	11.7	11.7	11.7	11.7	11.6	
72	77	11.4	11.4	11.3	11.3	11.3	11.3	11.2	11.2	11.2	11.2	11.1	
73	78	10.9	10.9	10.9	10.8	10.8	10.8	10.7	10.7	10.7	10.7	10.6	
74	79	10.5	10.4	10.4	10.4	10.3	10.3	10.3	10.3	10.2	10.2	10.1	
75	80	10.0	10.0	9.9	9.9	9.9	9.8	9.8	9.8	9.8	9.7		
76	81	9.6	9.5	9.5	9.5	9.4	9.4	9.4	9.4	9.3	9.3		
77	82	9.2	9.1	9.1	9.1	9.0	9.0	9.0	8.9	8.9	8.9		
78	83	8.8	8.7	8.7	8.7	8.6	8.6	8.5	8.5	8.5	8.4		
79	84	8.4	8.4	8.3	8.3	8.2	8.2	8.2	8.1	8.1	8.0		
80	85	8.0	8.0	7.9	7.9	7.9	7.8	7.8	7.7	7.7	7.6		
81	86	7.7	7.6	7.6	7.6	7.5	7.5	7.4	7.4	7.3	7.3		
82	87	7.4	7.3	7.3	7.2	7.2	7.1	7.1	7.0	7.0	6.9		

Table II.—Ordinary Joint Life and Last Survivor Annuities—Two Lives—Expected Return Multiples—Continued

Male	Female	Ages										
		Male 98	99	100	101	102	103	104	105	106	107	108
		Female 103	104	105	106	107	108	109	110	111	112	113
83	88	7.1	7.0	6.9	6.9	6.8	6.8	6.7	6.7	6.7	6.6	
84	89	6.8	6.7	6.6	6.6	6.5	6.5	6.4	6.4	6.3		

Male	Female	Ages										
		Male 86	87	88	89	90	91	92	93	94	95	96
		Female 91	92	93	94	95	96	97	98	99	100	101
85	90	7.9	7.7	7.5	7.4	7.2	7.1	7.0	6.9	6.8	6.7	6.6
86	91	7.7	7.5	7.3	7.1	7.0	6.8	6.7	6.6	6.5	6.4	6.4
87	92	7.5	7.3	7.1	6.9	6.8	6.6	6.5	6.4	6.3	6.2	6.1
88	93	7.3	7.1	6.9	6.7	6.6	6.4	6.3	6.2	6.1	6.0	5.9
89	94	7.1	6.9	6.7	6.5	6.4	6.2	6.1	6.0	5.9	5.8	5.7
90	95	7.0	6.8	6.6	6.4	6.2	6.1	5.9	5.8	5.7	5.6	5.5
91	96	6.8	6.6	6.4	6.2	6.1	5.9	5.8	5.7	5.5	5.4	5.3
92	97	6.7	6.5	6.3	6.1	5.9	5.8	5.6	5.5	5.4	5.3	5.2
93	98	6.6	6.4	6.2	6.0	5.8	5.7	5.5	5.4	5.2	5.1	5.0
94	99	6.5	6.3	6.1	5.9	5.7	5.5	5.4	5.2	5.1	5.0	4.9
95	100	6.4	6.2	6.0	5.8	5.6	5.4	5.3	5.1	5.0	4.9	4.7
96	101	6.4	6.1	5.9	5.7	5.5	5.3	5.2	5.0	4.9	4.7	4.6
97	102	6.3	6.1	5.8	5.6	5.4	5.2	5.1	4.9	4.8	4.6	4.5
98	103	6.2	6.0	5.8	5.5	5.3	5.1	5.0	4.8	4.7	4.5	4.4
99	104	6.2	5.9	5.7	5.5	5.2	5.1	4.9	4.7	4.6	4.4	4.3

Male	Female	Ages									
		Male 97	98	99	100	101	102	103	104	105	106
		Female 102	103	104	105	106	107	108	109	110	111
85	90	6.6	6.5	6.4	6.4	6.3	6.2	6.2	6.1	6.1	6.0
86	91	6.3	6.2	6.2	6.1	6.0	6.0	5.9	5.9	5.8	5.7
87	92	6.1	6.0	5.9	5.8	5.8	5.7	5.6	5.6	5.5	5.4
88	93	5.8	5.8	5.7	5.6	5.5	5.5	5.4	5.3	5.3	5.1
89	94	5.6	5.5	5.5	5.4	5.3	5.2	5.2	5.1	5.0	
90	95	5.4	5.3	5.2	5.2	5.1	5.0	4.9	4.9	4.8	
91	96	5.2	5.1	5.1	5.0	4.9	4.8	4.7	4.6	4.5	
92	97	5.1	5.0	4.9	4.8	4.7	4.6	4.5	4.4		
93	98	4.9	4.8	4.7	4.6	4.5	4.4	4.3	4.2		
94	99	4.8	4.7	4.6	4.5	4.4	4.3	4.1			
95	100	4.6	4.5	4.4	4.3	4.2	4.1	4.0			
96	101	4.5	4.4	4.3	4.2	4.1	3.9				
97	102	4.4	4.3	4.1	4.0	3.9	3.7				
98	103	4.3	4.1	4.0	3.9	3.7					
99	104	4.1	4.0	3.9	3.7						

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TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES

Male	Female	Ages														
		Male 6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
		Female 11	12	13	14	15	16	17	18	19	20	21	22	23	24	25
6	11	56.6	56.1	55.7	55.1	54.6	54.1	53.5	52.9	52.3	51.7	51.1	50.5	49.8	49.1	48.4
7	12	56.1	55.7	55.2	54.7	54.2	53.7	53.1	52.6	52.0	51.4	50.8	50.2	49.5	48.9	48.2
8	13	55.7	55.2	54.8	54.3	53.8	53.3	52.8	52.2	51.6	51.1	50.5	49.9	49.2	48.6	47.9
9	14	55.1	54.7	54.3	53.8	53.3	52.9	52.3	51.8	51.3	50.7	50.1	49.5	48.9	48.3	47.7
10	15	54.6	54.2	53.8	53.3	52.9	52.4	51.9	51.4	50.9	50.3	49.8	49.2	48.6	48.0	47.4
11	16	54.1	53.7	53.3	52.9	52.4	52.0	51.5	51.0	50.5	50.0	49.4	48.8	48.3	47.7	47.1
12	17	53.5	53.1	52.8	52.3	51.9	51.5	51.0	50.6	50.1	49.6	49.0	48.5	47.9	47.3	46.7
13	18	52.9	52.6	52.2	51.8	51.4	51.0	50.6	50.1	49.6	49.1	48.6	48.1	47.5	47.0	46.4
14	19	52.3	52.0	51.6	51.3	50.9	50.5	50.1	49.6	49.2	48.7	48.2	47.7	47.2	46.6	46.1
15	20	51.7	51.4	51.1	50.7	50.3	50.0	49.6	49.1	48.7	48.2	47.8	47.3	46.8	46.2	45.7
16	21	51.1	50.8	50.5	50.1	49.8	49.4	49.0	48.6	48.2	47.8	47.3	46.8	46.3	45.8	45.3
17	22	50.5	50.2	49.9	49.5	49.2	48.8	48.5	48.1	47.7	47.3	46.8	46.4	45.9	45.4	44.9
18	23	49.8	49.5	49.2	48.9	48.6	48.3	47.9	47.5	47.2	46.8	46.3	45.9	45.4	45.0	44.5
19	24	49.1	48.9	48.6	48.3	48.0	47.7	47.3	47.0	46.6	46.2	45.8	45.4	45.0	44.5	44.0
20	25	48.4	48.2	47.9	47.7	47.4	47.1	46.7	46.4	46.1	45.7	45.3	44.9	44.5	44.0	43.6

Male	Female	Ages													
		Male 21	22	23	24	25	26	27	28	29	30	31	32	33	34
		Female 26	27	28	29	30	31	32	33	34	35	36	37	38	39
6	11	47.7	47.0	46.3	45.6	44.8	44.1	43.3	42.5	41.8	41.0	40.2	39.4	38.6	37.8
7	12	47.5	46.8	46.1	45.4	44.6	43.9	43.2	42.4	41.6	40.9	40.1	39.3	38.5	37.7
8	13	47.3	46.6	45.9	45.2	44.5	43.7	43.0	42.2	41.5	40.7	39.9	39.2	38.4	37.6
9	14	47.0	46.3	45.6	45.0	44.2	43.5	42.8	42.1	41.3	40.6	39.8	39.0	38.3	37.5
10	15	46.7	46.1	45.4	44.7	44.0	43.3	42.6	41.9	41.1	40.4	39.7	38.9	38.1	37.4
11	16	46.4	45.8	45.1	44.5	43.8	43.1	42.4	41.7	41.0	40.2	39.5	38.8	38.0	37.2
12	17	46.1	45.5	44.9	44.2	43.6	42.9	42.2	41.5	40.8	40.1	39.3	38.6	37.9	37.1
13	18	45.8	45.2	44.6	43.9	43.3	42.6	42.0	41.3	40.6	39.9	39.2	38.4	37.7	37.0
14	19	45.5	44.9	44.3	43.7	43.0	42.4	41.7	41.0	40.4	39.7	39.0	38.3	37.5	36.8
15	20	45.1	44.6	44.0	43.4	42.7	42.1	41.5	40.8	40.1	39.5	38.8	38.1	37.4	36.6
16	21	44.8	44.2	43.6	43.0	42.4	41.8	41.2	40.5	39.9	39.2	38.6	37.9	37.2	36.5
17	22	44.4	43.8	43.3	42.7	42.1	41.5	40.9	40.3	39.6	39.0	38.3	37.7	37.0	36.3
18	23	44.0	43.5	42.9	42.4	41.8	41.2	40.6	40.0	39.4	38.7	38.1	37.4	36.8	36.1
19	24	43.6	43.1	42.5	42.0	41.4	40.9	40.3	39.7	39.1	38.5	37.8	37.2	36.5	35.9
20	25	43.1	42.6	42.1	41.6	41.1	40.5	40.0	39.4	38.8	38.2	37.6	36.9	36.3	35.7
21	26	42.7	42.2	41.7	41.2	40.7	40.2	39.6	39.1	38.5	37.9	37.3	36.7	36.1	35.4
22	27	42.2	41.8	41.3	40.8	40.3	39.8	39.3	38.7	38.2	37.6	37.0	36.4	35.8	35.2
23	28	41.7	41.3	40.8	40.4	39.9	39.4	38.9	38.4	37.8	37.3	36.7	36.1	35.5	34.9
24	29	41.2	40.8	40.4	39.9	39.5	39.0	38.5	38.0	37.5	36.9	36.4	35.8	35.2	34.6
25	30	40.7	40.3	39.9	39.5	39.0	38.6	38.1	37.6	37.1	36.6	36.0	35.5	34.9	34.4
26	31	40.2	39.8	39.4	39.0	38.6	38.1	37.7	37.2	36.7	36.2	35.7	35.2	34.6	34.1
27	32	39.6	39.3	38.9	38.5	38.1	37.7	37.2	36.8	36.3	35.8	35.3	34.8	34.3	33.7
28	33	39.1	38.7	38.4	38.0	37.6	37.2	36.8	36.3	35.9	35.4	34.9	34.5	33.9	33.4
29	34	38.5	38.2	37.8	37.5	37.1	36.7	36.3	35.9	35.5	35.0	34.6	34.1	33.6	33.1
30	35	37.9	37.6	37.3	36.9	36.6	36.2	35.8	35.4	35.0	34.6	34.1	33.7	33.2	32.7
31	36	37.3	37.0	36.7	36.4	36.0	35.7	35.3	34.9	34.6	34.1	33.7	33.3	32.8	32.3
32	37	36.7	36.4	36.1	35.8	35.5	35.2	34.8	34.5	34.1	33.7	33.3	32.9	32.4	32.0
33	38	36.1	35.8	35.5	35.2	34.9	34.6	34.3	33.9	33.6	33.2	32.8	32.4	32.0	31.6
34	39	35.4	35.2	34.9	34.6	34.4	34.1	33.7	33.4	33.1	32.7	32.3	32.0	31.6	31.1

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Male	Female	Ages														
		Male 35	36	37	38	39	40	41	42	43	44	45	46	47	48	49
		Female 40	41	42	43	44	45	46	47	48	49	50	51	52	53	54
6	11	37.0	36.2	35.4	34.6	33.8	33.0	32.2	31.4	30.6	29.8	29.0	28.2	27.5	26.7	25.9
7	12	36.9	36.1	35.3	34.5	33.7	32.9	32.1	31.3	30.5	29.8	29.0	28.2	27.4	26.7	25.9
8	13	36.8	36.0	35.2	34.4	33.7	32.9	32.1	31.3	30.5	29.7	28.9	28.2	27.4	26.6	25.9
9	14	36.7	35.9	35.1	34.4	33.6	32.8	32.0	31.2	30.4	29.7	28.9	28.1	27.3	26.6	25.8
10	15	36.6	35.8	35.1	34.3	33.5	32.7	31.9	31.2	30.4	29.6	28.8	28.1	27.3	26.5	25.8
11	16	36.5	35.7	34.9	34.2	33.4	32.6	31.9	31.1	30.3	29.5	28.8	28.0	27.3	26.5	25.7
12	17	36.4	35.6	34.8	34.1	33.3	32.5	31.8	31.0	30.2	29.5	28.7	28.0	27.2	26.4	25.7
13	18	36.2	35.5	34.7	34.0	33.2	32.4	31.7	30.9	30.2	29.4	28.7	27.9	27.1	26.4	25.7
14	19	36.1	35.3	34.6	33.8	33.1	32.3	31.6	30.8	30.1	29.3	28.6	27.8	27.1	26.3	25.6
15	20	35.9	35.2	34.5	33.7	33.0	32.2	31.5	30.7	30.0	29.3	28.5	27.8	27.0	26.3	25.6
16	21	35.8	35.0	34.3	33.6	32.9	32.1	31.4	30.6	29.9	29.2	28.4	27.7	27.0	26.2	25.5
17	22	35.6	34.9	34.2	33.4	32.7	32.0	31.3	30.5	29.8	29.1	28.3	27.6	26.9	26.2	25.4
18	23	35.4	34.7	34.0	33.3	32.6	31.9	31.2	30.4	29.7	29.0	28.3	27.5	26.8	26.1	25.4
19	24	35.2	34.5	33.8	33.1	32.4	31.7	31.0	30.3	29.6	28.9	28.2	27.4	26.7	26.0	25.3
20	25	35.0	34.3	33.7	33.0	32.3	31.6	30.9	30.2	29.5	28.8	28.1	27.3	26.6	25.9	25.2
21	26	34.8	34.1	33.5	32.8	32.1	31.4	30.7	30.0	29.3	28.6	27.9	27.2	26.5	25.8	25.1
22	27	34.5	33.9	33.3	32.6	31.9	31.3	30.6	29.9	29.2	28.5	27.8	27.1	26.4	25.7	25.1
23	28	34.3	33.7	33.0	32.4	31.7	31.1	30.4	29.7	29.1	28.4	27.7	27.0	26.3	25.6	25.0
24	29	34.0	33.4	32.8	32.2	31.5	30.9	30.2	29.6	28.9	28.2	27.6	26.9	26.2	25.5	24.9
25	30	33.8	33.2	32.6	32.0	31.3	30.7	30.1	29.4	28.8	28.1	27.4	26.8	26.1	25.4	24.8
26	31	33.5	32.9	32.3	31.7	31.1	30.5	29.9	29.2	28.6	27.9	27.3	26.6	26.0	25.3	24.6
27	32	33.2	32.6	32.1	31.5	30.9	30.3	29.6	29.0	28.4	27.8	27.1	26.5	25.8	25.2	24.5
28	33	32.9	32.3	31.8	31.2	30.6	30.0	29.4	28.8	28.2	27.6	27.0	26.3	25.7	25.0	24.4
29	34	32.6	32.0	31.5	30.9	30.4	29.8	29.2	28.6	28.0	27.4	26.8	26.2	25.5	24.9	24.3
30	35	32.2	31.7	31.2	30.6	30.1	29.5	29.0	28.4	27.8	27.2	26.6	26.0	25.4	24.7	24.1
31	36	31.9	31.4	30.9	30.3	29.8	29.3	28.7	28.1	27.6	27.0	26.4	25.8	25.2	24.6	24.0
32	37	31.5	31.0	30.5	30.0	29.5	29.0	28.4	27.9	27.3	26.8	26.2	25.6	25.0	24.4	23.8
33	38	31.1	30.7	30.2	29.7	29.2	28.7	28.2	27.6	27.1	26.5	26.0	25.4	24.8	24.2	23.6
34	39	30.7	30.3	29.8	29.3	28.9	28.4	27.9	27.3	26.8	26.3	25.7	25.2	24.6	24.0	23.5

Male	Female	Ages														
		Male 50	51	52	53	54	55	56	57	58	59	60	61	62	63	
		Female 55	56	57	58	59	60	61	62	63	64	65	66	67	68	
6	11	25.2	24.4	23.7	22.9	22.2	21.5	20.8	20.1	19.4	18.7	18.0	17.4	16.7	16.1	
7	12	25.1	24.4	23.6	22.9	22.2	21.5	20.8	20.1	19.4	18.7	18.0	17.4	16.7	16.1	
8	13	25.1	24.4	23.6	22.9	22.2	21.4	20.7	20.0	19.4	18.7	18.0	17.4	16.7	16.1	
9	14	25.1	24.3	23.6	22.9	22.1	21.4	20.7	20.0	19.3	18.7	18.0	17.3	16.7	16.1	
10	15	25.0	24.3	23.6	22.8	22.1	21.4	20.7	20.0	19.3	18.6	18.0	17.3	16.7	16.1	
11	16	25.0	24.3	23.5	22.8	22.1	21.4	20.7	20.0	19.3	18.6	18.0	17.3	16.7	16.1	
12	17	25.0	24.2	23.5	22.8	22.1	21.4	20.7	20.0	19.3	18.6	18.0	17.3	16.7	16.0	
13	18	24.9	24.2	23.5	22.7	22.0	21.3	20.6	19.9	19.3	18.6	17.9	17.3	16.7	16.0	
14	19	24.9	24.1	23.4	22.7	22.0	21.3	20.6	19.9	19.2	18.6	17.9	17.3	16.6	16.0	
15	20	24.8	24.1	23.4	22.7	22.0	21.3	20.6	19.9	19.2	18.5	17.9	17.3	16.6	16.0	
16	21	24.8	24.0	23.3	22.6	21.9	21.2	20.5	19.9	19.2	18.5	17.9	17.2	16.6	16.0	
17	22	24.7	24.0	23.3	22.6	21.9	21.2	20.5	19.8	19.2	18.5	17.8	17.2	16.6	16.0	
18	23	24.7	23.9	23.2	22.5	21.8	21.1	20.5	19.8	19.1	18.5	17.8	17.2	16.6	15.9	
19	24	24.6	23.9	23.2	22.5	21.8	21.1	20.4	19.8	19.1	18.4	17.8	17.2	16.5	15.9	
20	25	24.5	23.8	23.1	22.4	21.7	21.1	20.4	19.7	19.1	18.4	17.8	17.1	16.5	15.9	
21	26	24.4	23.7	23.1	22.4	21.7	21.0	20.3	19.7	19.0	18.4	17.7	17.1	16.5	15.9	
22	27	24.4	23.7	23.0	22.3	21.6	21.0	20.3	19.6	19.0	18.3	17.7	17.1	16.5	15.9	
23	28	24.3	23.6	22.9	22.2	21.6	20.9	20.2	19.6	18.9	18.3	17.7	17.0	16.4	15.8	
24	29	24.2	23.5	22.8	22.2	21.5	20.8	20.2	19.5	18.9	18.3	17.6	17.0	16.4	15.8	
25	30	24.1	23.4	22.8	22.1	21.4	20.8	20.1	19.5	18.8	18.2	17.6	17.0	16.4	15.8	

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Male	Female	Ages													
		Male 50	51	52	53	54	55	56	57	58	59	60	61	62	63
		Female 55	56	57	58	59	60	61	62	63	64	65	66	67	68
26	31	24.0	23.3	22.7	22.0	21.4	20.7	20.1	19.4	18.8	18.2	17.5	16.9	16.3	15.7
27	32	23.9	23.2	22.6	21.9	21.3	20.6	20.0	19.4	18.7	18.1	17.5	16.9	16.3	15.7
28	33	23.8	23.1	22.5	21.8	21.2	20.6	19.9	19.3	18.7	18.1	17.4	16.8	16.2	15.6
29	34	23.6	23.0	22.4	21.7	21.1	20.5	19.8	19.2	18.6	18.0	17.4	16.8	16.2	15.6
30	35	23.5	22.9	22.3	21.6	21.0	20.4	19.8	19.1	18.5	17.9	17.3	16.7	16.1	15.6
31	36	23.4	22.7	22.1	21.5	20.9	20.3	19.7	19.1	18.5	17.9	17.3	16.7	16.1	15.5
32	37	23.2	22.6	22.0	21.4	20.8	20.2	19.6	19.0	18.4	17.8	17.2	16.6	16.0	15.5
33	38	23.1	22.5	21.9	21.3	20.7	20.1	19.5	18.9	18.3	17.7	17.1	16.5	16.0	15.4
34	39	22.9	22.3	21.7	21.1	20.5	20.0	19.4	18.8	18.2	17.6	17.0	16.5	15.9	15.3

Male	Female	Ages													
		Male 64	65	66	67	68	69	70	71	72	73	74	75	76	77	78
		Female 69	70	71	72	73	74	75	76	77	78	79	80	81	82	83
6	11	15.5	14.9	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.6	9.1	8.7	8.2
7	12	15.5	14.9	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.6	9.1	8.7	8.2
8	13	15.5	14.9	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.6	9.1	8.7	8.2
9	14	15.5	14.9	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.7	8.2
10	15	15.4	14.8	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.7	8.2
11	16	15.4	14.8	14.2	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.7	8.2
12	17	15.4	14.8	14.2	13.7	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
13	18	15.4	14.8	14.2	13.6	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
14	19	15.4	14.8	14.2	13.6	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
15	20	15.4	14.8	14.2	13.6	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
16	21	15.4	14.8	14.2	13.6	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
17	22	15.4	14.8	14.2	13.6	13.0	12.5	12.0	11.5	10.9	10.5	10.0	9.5	9.1	8.6	8.2
18	23	15.3	14.7	14.2	13.6	13.0	12.5	12.0	11.4	10.9	10.4	10.0	9.5	9.1	8.6	8.2
19	24	15.3	14.7	14.1	13.6	13.0	12.5	12.0	11.4	10.9	10.4	10.0	9.5	9.1	8.6	8.2
20	25	15.3	14.7	14.1	13.6	13.0	12.5	11.9	11.4	10.9	10.4	10.0	9.5	9.0	8.6	8.2
21	26	15.3	14.7	14.1	13.5	13.0	12.5	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
22	27	15.3	14.7	14.1	13.5	13.0	12.4	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
23	28	15.2	14.6	14.1	13.5	13.0	12.4	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
24	29	15.2	14.6	14.0	13.5	12.9	12.4	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
25	30	15.2	14.6	14.0	13.5	12.9	12.4	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
26	31	15.1	14.6	14.0	13.4	12.9	12.4	11.9	11.3	10.8	10.4	9.9	9.4	9.0	8.6	8.2
27	32	15.1	14.5	14.0	13.4	12.9	12.4	11.8	11.3	10.8	10.4	9.9	9.4	9.0	8.6	8.2
28	33	15.1	14.5	13.9	13.4	12.9	12.3	11.8	11.3	10.8	10.3	9.9	9.4	9.0	8.6	8.1
29	34	15.0	14.5	13.9	13.4	12.8	12.3	11.8	11.3	10.8	10.3	9.9	9.4	9.0	8.5	8.1
30	35	15.0	14.4	13.9	13.3	12.8	12.3	11.8	11.3	10.8	10.3	9.8	9.4	9.0	8.5	8.1
31	36	14.9	14.4	13.8	13.3	12.8	12.2	11.7	11.2	10.8	10.3	9.8	9.4	8.9	8.5	8.1
32	37	14.9	14.3	13.8	13.3	12.7	12.2	11.7	11.2	10.7	10.3	9.8	9.4	8.9	8.5	8.1
33	38	14.8	14.3	13.8	13.2	12.7	12.2	11.7	11.2	10.7	10.2	9.8	9.3	8.9	8.5	8.1
34	39	14.8	14.2	13.7	13.2	12.7	12.2	11.7	11.2	10.7	10.2	9.8	9.3	8.9	8.5	8.1

Male	Female	Ages														
		Male 79	80	81	82	83	84	85	86	87	88	89	90	91	92	93
		Female 84	85	86	87	88	89	90	91	92	93	94	95	96	97	98
6	11	7.8	7.4	7.1	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
7	12	7.8	7.4	7.1	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
8	13	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
9	14	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
10	15	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
11	16	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Male	Female	Ages														
		Male 79	80	81	82	83	84	85	86	87	88	89	90	91	92	93
		Female 84	85	86	87	88	89	90	91	92	93	94	95	96	97	98
12	17	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
13	18	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.1	4.8	4.5	4.2	4.0	3.7	3.5
14	19	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
15	20	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
16	21	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
17	22	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
18	23	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
19	24	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
20	25	7.8	7.4	7.0	6.7	6.3	6.0	5.6	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
21	26	7.8	7.4	7.0	6.7	6.3	6.0	5.6	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
22	27	7.8	7.4	7.0	6.7	6.3	6.0	5.6	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
23	28	7.8	7.4	7.0	6.6	6.3	6.0	5.6	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
24	29	7.8	7.4	7.0	6.6	6.3	6.0	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
25	30	7.8	7.4	7.0	6.6	6.3	6.0	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
26	31	7.8	7.4	7.0	6.6	6.3	6.0	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
27	32	7.7	7.4	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
28	33	7.7	7.4	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
29	34	7.7	7.3	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
30	35	7.7	7.3	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
31	36	7.7	7.3	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
32	37	7.7	7.3	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
33	38	7.7	7.3	6.9	6.6	6.2	5.9	5.6	5.3	5.0	4.7	4.5	4.2	3.9	3.7	3.5
34	39	7.7	7.3	6.9	6.6	6.2	5.9	5.6	5.3	5.0	4.7	4.4	4.2	3.9	3.7	3.5

Male	Female	Ages														
		Male 94	95	96	97	98	99	100	101	102	103	104	105	106	107	108
		Female 99	100	101	102	103	104	105	106	107	108	109	110	111	112	113
6	11	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
7	12	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
8	13	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
9	14	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
10	15	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
11	16	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
12	17	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
13	18	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
14	19	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
15	20	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
16	21	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
17	22	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
18	23	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
19	24	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
20	25	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
21	26	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
22	27	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
23	28	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
24	29	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
25	30	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
26	31	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
27	32	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
28	33	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
29	34	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
30	35	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
31	36	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
32	37	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
33	38	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Male	Female	Ages														
		Male 94	95	96	97	98	99	100	101	102	103	104	105	106	107	108
		Female 99	100	101	102	103	104	105	106	107	108	109	110	111	112	113
34	39	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7

Male	Female	Ages												
		Male 35	36	37	38	39	40	41	42	43	44	45	46	47
		Female 40	41	42	43	44	45	46	47	48	49	50	51	52
35	40	30.3	29.9	29.4	29.0	28.5	28.0	27.5	27.0	26.5	26.0	25.5	24.9	24.4
36	41	29.9	29.5	29.0	28.6	28.2	27.7	27.2	26.7	26.2	25.7	25.2	24.7	24.2
37	42	29.4	29.0	28.6	28.2	27.8	27.3	26.9	26.4	25.9	25.5	25.0	24.4	23.9
38	43	29.0	28.6	28.2	27.8	27.4	27.0	26.5	26.1	25.6	25.2	24.7	24.2	23.7
39	44	28.5	28.2	27.8	27.4	27.0	26.6	26.2	25.8	25.3	24.8	24.4	23.9	23.4
40	45	28.0	27.7	27.3	27.0	26.6	26.2	25.8	25.4	25.0	24.5	24.1	23.6	23.1
41	46	27.5	27.2	26.9	26.5	26.2	25.8	25.4	25.0	24.6	24.2	23.8	23.3	22.9
42	47	27.0	26.7	26.4	26.1	25.8	25.4	25.0	24.6	24.2	23.8	23.4	23.0	22.6
43	48	26.5	26.2	25.9	25.6	25.3	25.0	24.6	24.2	23.9	23.5	23.1	22.7	22.2
44	49	26.0	25.7	25.5	25.2	24.8	24.5	24.2	23.8	23.5	23.1	22.7	22.3	21.9
45	50	25.5	25.2	25.0	24.7	24.4	24.1	23.8	23.4	23.1	22.7	22.4	22.0	21.6
46	51	24.9	24.7	24.4	24.2	23.9	23.6	23.3	23.0	22.7	22.3	22.0	21.6	21.2
47	52	24.4	24.2	23.9	23.7	23.4	23.1	22.9	22.6	22.2	21.9	21.6	21.2	20.9

Male	Female	Ages												
		Male 48	49	50	51	52	53	54	55	56	57	58	59	60
		Female 53	54	55	56	57	58	59	60	61	62	63	64	65
35	40	23.8	23.3	22.7	22.1	21.6	21.0	20.4	19.8	19.3	18.7	18.1	17.5	17.0
36	41	23.6	23.1	22.5	22.0	21.4	20.8	20.3	19.7	19.1	18.6	18.0	17.4	16.9
37	42	23.4	22.9	22.3	21.8	21.2	20.7	20.1	19.6	19.0	18.4	17.9	17.3	16.8
38	43	23.2	22.6	22.1	21.6	21.1	20.5	20.0	19.4	18.9	18.3	17.8	17.2	16.7
39	44	22.9	22.4	21.9	21.4	20.9	20.3	19.8	19.3	18.7	18.2	17.7	17.1	16.6
40	45	22.7	22.2	21.7	21.2	20.7	20.1	19.6	19.1	18.6	18.0	17.5	17.0	16.5
41	46	22.4	21.9	21.4	20.9	20.4	19.9	19.4	18.9	18.4	17.9	17.4	16.9	16.3
42	47	22.1	21.6	21.2	20.7	20.2	19.7	19.2	18.7	18.2	17.7	17.2	16.7	16.2
43	48	21.8	21.4	20.9	20.5	20.0	19.5	19.0	18.6	18.1	17.6	17.1	16.6	16.1
44	49	21.5	21.1	20.6	20.2	19.8	19.3	18.8	18.4	17.9	17.4	16.9	16.4	15.9
45	50	21.2	20.8	20.4	19.9	19.5	19.1	18.6	18.1	17.7	17.2	16.7	16.3	15.8
46	51	20.9	20.5	20.1	19.7	19.2	18.8	18.4	17.9	17.5	17.0	16.6	16.1	15.6
47	52	20.5	20.1	19.8	19.4	19.0	18.5	18.1	17.7	17.3	16.8	16.4	15.9	15.5
48	53	20.2	19.8	19.4	19.1	18.7	18.3	17.9	17.5	17.0	16.6	16.2	15.7	15.3
49	54	19.8	19.5	19.1	18.8	18.4	18.0	17.6	17.2	16.8	16.4	16.0	15.5	15.1
50	55	19.4	19.1	18.8	18.4	18.1	17.7	17.3	16.9	16.6	16.2	15.8	15.3	14.9
51	56	19.1	18.8	18.4	18.1	17.8	17.4	17.0	16.7	16.3	15.9	15.5	15.1	14.7
52	57	18.7	18.4	18.1	17.8	17.4	17.1	16.8	16.4	16.0	15.7	15.3	14.9	14.5
53	58	18.3	18.0	17.7	17.4	17.1	16.8	16.4	16.1	15.8	15.4	15.1	14.7	14.3
54	59	17.9	17.6	17.3	17.0	16.8	16.4	16.1	15.8	15.5	15.1	14.8	14.4	14.1
55	60	17.5	17.2	16.9	16.7	16.4	16.1	15.8	15.5	15.2	14.9	14.5	14.2	13.9
56	61	17.0	16.8	16.6	16.3	16.0	15.8	15.5	15.2	14.9	14.6	14.3	13.9	13.6
57	62	16.6	16.4	16.2	15.9	15.7	15.4	15.1	14.9	14.6	14.3	14.0	13.7	13.4
58	63	16.2	16.0	15.8	15.5	15.3	15.1	14.8	14.5	14.3	14.0	13.7	13.4	13.1
59	64	15.7	15.5	15.3	15.1	14.9	14.7	14.4	14.2	13.9	13.7	13.4	13.1	12.8
60	65	15.3	15.1	14.9	14.7	14.5	14.3	14.1	13.9	13.6	13.4	13.1	12.8	12.6

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Male	Female	Ages												
		Male 61	62	63	64	65	66	67	68	69	70	71	72	73
		Female 66	67	68	69	70	71	72	73	74	74	76	77	78
35	40	16.4	15.8	15.3	14.7	14.2	13.7	13.1	12.6	12.1	11.6	11.1	10.7	10.2
36	41	16.3	15.8	15.2	14.7	14.1	13.6	13.1	12.6	12.1	11.6	11.1	10.6	10.2
37	42	16.2	15.7	15.1	14.6	14.1	13.6	13.0	12.5	12.0	11.5	11.1	10.6	10.1
38	43	16.1	15.6	15.1	14.5	14.0	13.5	13.0	12.5	12.0	11.5	11.0	10.6	10.1
39	44	16.0	15.5	15.0	14.5	13.9	13.4	12.9	12.4	11.9	11.5	11.0	10.5	10.1
40	45	15.9	15.4	14.9	14.4	13.9	13.4	12.9	12.4	11.9	11.4	11.0	10.5	10.0
41	46	15.8	15.3	14.8	14.3	13.8	13.3	12.8	12.3	11.8	11.4	10.9	10.5	10.0
42	47	15.7	15.2	14.7	14.2	13.7	13.2	12.7	12.3	11.8	11.3	10.9	10.4	10.0
43	48	15.6	15.1	14.6	14.1	13.6	13.1	12.7	12.2	11.7	11.3	10.8	10.4	9.9
44	49	15.5	15.0	14.5	14.0	13.5	13.1	12.6	12.1	11.7	11.2	10.8	10.3	9.9
45	50	15.3	14.8	14.4	13.9	13.4	13.0	12.5	12.0	11.6	11.1	10.7	10.3	9.8
46	51	15.2	14.7	14.2	13.8	13.3	12.9	12.4	12.0	11.5	11.1	10.6	10.2	9.8
47	52	15.0	14.6	14.1	13.7	13.2	12.8	12.3	11.9	11.4	11.0	10.6	10.1	9.7
48	53	14.9	14.4	14.0	13.5	13.1	12.6	12.2	11.8	11.3	10.9	10.5	10.1	9.7
49	54	14.7	14.3	13.8	13.4	13.0	12.5	12.1	11.7	11.3	10.8	10.4	10.0	9.6
50	55	14.5	14.1	13.7	13.3	12.8	12.4	12.0	11.6	11.2	10.7	10.3	9.9	9.5
51	56	14.3	13.9	13.5	13.1	12.7	12.3	11.9	11.5	11.1	10.7	10.3	9.9	9.5
52	57	14.1	13.7	13.3	12.9	12.5	12.1	11.7	11.3	10.9	10.6	10.2	9.8	9.4
53	58	13.9	13.6	13.2	12.8	12.4	12.0	11.6	11.2	10.8	10.5	10.1	9.7	9.3
54	59	13.7	13.4	13.0	12.6	12.2	11.9	11.5	11.1	10.7	10.3	10.0	9.6	9.2
55	60	13.5	13.2	12.8	12.4	12.1	11.7	11.3	11.0	10.6	10.2	9.9	9.5	9.1
56	61	13.3	12.9	12.6	12.2	11.9	11.5	11.2	10.8	10.5	10.1	9.8	9.4	9.0
57	62	13.0	12.7	12.4	12.1	11.7	11.4	11.0	10.7	10.3	10.0	9.6	9.3	8.9
58	63	12.8	12.5	12.2	11.8	11.5	11.2	10.9	10.5	10.2	9.8	9.5	9.2	8.8
59	64	12.6	12.3	11.9	11.6	11.3	11.0	10.7	10.4	10.0	9.7	9.4	9.1	8.7
60	65	12.3	12.0	11.7	11.4	11.1	10.8	10.5	10.2	9.9	9.6	9.3	8.9	8.6
61	66	12.0	11.8	11.5	11.2	10.9	10.6	10.3	10.0	9.7	9.4	9.1	8.8	8.5
62	67	11.8	11.5	11.2	11.0	10.7	10.4	10.1	9.8	9.6	9.3	9.0	8.7	8.4
63	68	11.5	11.2	11.0	10.7	10.5	10.2	9.9	9.7	9.4	9.1	8.8	8.5	8.2
64	69	11.2	11.0	10.7	10.5	10.2	10.0	9.7	9.5	9.2	8.9	8.7	8.4	8.1
65	70	10.9	10.7	10.5	10.2	10.0	9.8	9.5	9.3	9.0	8.8	8.5	8.2	8.0
66	71	10.6	10.4	10.2	10.0	9.8	9.5	9.3	9.1	8.8	8.6	8.3	8.1	7.8
67	72	10.3	10.1	9.9	9.7	9.5	9.3	9.1	8.9	8.6	8.4	8.1	7.9	7.7
68	73	10.0	9.8	9.7	9.5	9.3	9.1	8.9	8.6	8.4	8.2	8.0	7.7	7.5
69	74	9.7	9.6	9.4	9.2	9.0	8.8	8.6	8.4	8.2	8.0	7.8	7.6	7.3
70	75	9.4	9.3	9.1	8.9	8.8	8.6	8.4	8.2	8.0	7.8	7.6	7.4	7.2
71	76	9.1	9.0	8.8	8.7	8.5	8.3	8.1	8.0	7.8	7.6	7.4	7.2	7.0
72	77	8.8	8.7	8.5	8.4	8.2	8.1	7.9	7.7	7.6	7.4	7.2	7.0	6.8
73	78	8.5	8.4	8.2	8.1	8.0	7.8	7.7	7.5	7.3	7.2	7.0	6.8	6.7

Male	Female	Ages												
		Male 74	75	76	77	78	79	80	81	82	83	84	85	86
		Female 79	80	81	82	83	84	85	86	87	88	89	90	91
35	40	9.7	9.3	8.9	8.5	8.1	7.7	7.3	6.9	6.6	6.2	5.9	5.6	5.3
36	41	9.7	9.3	8.9	8.4	8.0	7.7	7.3	6.9	6.6	6.2	5.9	5.6	5.3
37	42	9.7	9.3	8.8	8.4	8.0	7.6	7.3	6.9	6.5	6.2	5.9	5.6	5.3
38	43	9.7	9.2	8.8	8.4	8.0	7.6	7.2	6.9	6.5	6.2	5.9	5.6	5.3
39	44	9.6	9.2	8.8	8.4	8.0	7.6	7.2	6.9	6.5	6.2	5.9	5.6	5.3
40	45	9.6	9.2	8.8	8.4	8.0	7.6	7.2	6.9	6.5	6.2	5.9	5.5	5.2
41	46	9.6	9.2	8.7	8.3	7.9	7.6	7.2	6.8	6.5	6.2	5.8	5.5	5.2
42	47	9.5	9.1	8.7	8.3	7.9	7.5	7.2	6.8	6.5	6.2	5.8	5.5	5.2
43	48	9.5	9.1	8.7	8.3	7.9	7.5	7.2	6.8	6.5	6.1	5.8	5.5	5.2
44	49	9.5	9.0	8.6	8.2	7.9	7.5	7.1	6.8	6.4	6.1	5.8	5.5	5.2
45	50	9.4	9.0	8.6	8.2	7.8	7.5	7.1	6.8	6.4	6.1	5.8	5.5	5.2
46	51	9.4	9.0	8.6	8.2	7.8	7.4	7.1	6.7	6.4	6.1	5.8	5.5	5.2
47	52	9.3	8.9	8.5	8.1	7.8	7.4	7.1	6.7	6.4	6.1	5.8	5.5	5.2
48	53	9.3	8.9	8.5	8.1	7.7	7.4	7.0	6.7	6.4	6.0	5.7	5.4	5.1

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Male	Female	Ages												
		Male 74	75	76	77	78	79	80	81	82	83	84	85	86
		Female 79	80	81	82	83	84	85	86	87	88	89	90	91
49	54	9.2	8.8	8.4	8.1	7.7	7.3	7.0	6.7	6.3	6.0	5.7	5.4	5.1
50	55	9.1	8.8	8.4	8.0	7.7	7.3	7.0	6.6	6.3	6.0	5.7	5.4	5.1
51	56	9.1	8.7	8.3	8.0	7.6	7.3	6.9	6.6	6.3	6.0	5.7	5.4	5.1
52	57	9.0	8.6	8.3	7.9	7.6	7.2	6.9	6.6	6.2	5.9	5.6	5.4	5.1
53	58	8.9	8.6	8.2	7.9	7.5	7.2	6.9	6.5	6.2	5.9	5.6	5.3	5.1
54	59	8.9	8.5	8.2	7.8	7.5	7.1	6.8	6.5	6.2	5.9	5.6	5.3	5.0
55	60	8.8	8.4	8.1	7.7	7.4	7.1	6.8	6.4	6.1	5.8	5.6	5.3	5.0
56	61	8.7	8.4	8.0	7.7	7.3	7.0	6.7	6.4	6.1	5.8	5.5	5.3	5.0
57	62	8.6	8.3	7.9	7.6	7.3	7.0	6.7	6.4	6.1	5.8	5.5	5.2	5.0
58	63	8.5	8.2	7.9	7.5	7.2	6.9	6.6	6.3	6.0	5.7	5.5	5.2	4.9
59	64	8.4	8.1	7.8	7.5	7.1	6.8	6.5	6.3	6.0	5.7	5.4	5.2	4.9
60	65	8.3	8.0	7.7	7.4	7.1	6.8	6.5	6.2	5.9	5.6	5.4	5.1	4.9
61	66	8.2	7.9	7.6	7.3	7.0	6.7	6.4	6.1	5.9	5.6	5.3	5.1	4.8
62	67	8.1	7.8	7.5	7.2	6.9	6.6	6.4	6.1	5.8	5.5	5.3	5.0	4.8
63	68	8.0	7.7	7.4	7.1	6.8	6.6	6.3	6.0	5.7	5.5	5.2	5.0	4.7
64	69	7.8	7.6	7.3	7.0	6.7	6.5	6.2	5.9	5.7	5.4	5.2	4.9	4.7
65	70	7.7	7.4	7.2	6.9	6.6	6.4	6.1	5.9	5.6	5.4	5.1	4.9	4.7
66	71	7.6	7.3	7.1	6.8	6.5	6.3	6.0	5.8	5.5	5.3	5.1	4.8	4.6
67	72	7.4	7.2	6.9	6.7	6.4	6.2	6.0	5.7	5.5	5.2	5.0	4.8	4.6
68	73	7.3	7.0	6.8	6.6	6.3	6.1	5.9	5.6	5.4	5.2	4.9	4.7	4.5
69	74	7.1	6.9	6.7	6.4	6.2	6.0	5.8	5.5	5.3	5.1	4.9	4.7	4.5
70	75	7.0	6.8	6.5	6.3	6.1	5.9	5.7	5.4	5.2	5.0	4.8	4.6	4.4
71	76	6.8	6.6	6.4	6.2	6.0	5.8	5.6	5.3	5.1	4.9	4.7	4.5	4.3
72	77	6.6	6.4	6.3	6.1	5.9	5.7	5.5	5.3	5.0	4.9	4.7	4.5	4.3
73	78	6.5	6.3	6.1	5.9	5.7	5.5	5.3	5.1	5.0	4.8	4.6	4.4	4.2
74	79	6.3	6.1	6.0	5.8	5.6	5.4	5.2	5.0	4.9	4.7	4.5	4.3	4.1
75	80	6.1	6.0	5.8	5.6	5.5	5.3	5.1	4.9	4.8	4.6	4.4	4.2	4.1
76	81	6.0	5.8	5.6	5.5	5.3	5.2	5.0	4.8	4.7	4.5	4.3	4.1	4.0
77	82	5.8	5.6	5.5	5.3	5.2	5.0	4.9	4.7	4.5	4.4	4.2	4.1	3.9
78	83	5.6	5.5	5.3	5.2	5.0	4.9	4.7	4.6	4.4	4.3	4.1	4.0	3.8
79	84	5.4	5.3	5.2	5.0	4.9	4.7	4.6	4.5	4.3	4.2	4.0	3.9	3.7
80	85	5.2	5.1	5.0	4.9	4.7	4.6	4.5	4.3	4.2	4.1	3.9	3.8	3.6
81	86	5.0	4.9	4.8	4.7	4.6	4.5	4.3	4.2	4.1	3.9	3.8	3.7	3.6
82	87	4.9	4.8	4.7	4.5	4.4	4.3	4.2	4.1	4.0	3.8	3.7	3.6	3.5
83	88	4.7	4.6	4.5	4.4	4.3	4.2	4.1	3.9	3.8	3.7	3.6	3.5	3.4
84	89	4.5	4.4	4.3	4.2	4.1	4.0	3.9	3.8	3.7	3.6	3.5	3.4	3.3
85	90	4.3	4.2	4.1	4.1	4.0	3.9	3.8	3.7	3.6	3.5	3.4	3.3	3.2
86	91	4.1	4.1	4.0	3.9	3.8	3.7	3.6	3.6	3.5	3.4	3.3	3.2	3.1

Male	Female	Ages										
		Male 87	88	89	90	91	92	93	94	95	96	97
		Female 92	93	94	95	96	97	98	99	100	101	102
35	40	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.9	2.7
36	41	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.9	2.7
37	42	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.9	2.7
38	43	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.8	2.6
39	44	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.0	2.8	2.6
40	45	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.0	2.8	2.6
41	46	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.2	3.0	2.8	2.6
42	47	4.9	4.7	4.4	4.2	3.9	3.7	3.5	3.2	3.0	2.8	2.6
43	48	4.9	4.7	4.4	4.1	3.9	3.7	3.5	3.2	3.0	2.8	2.6
44	49	4.9	4.7	4.4	4.1	3.9	3.7	3.4	3.2	3.0	2.8	2.6
45	50	4.9	4.6	4.4	4.1	3.9	3.7	3.4	3.2	3.0	2.8	2.6
46	51	4.9	4.6	4.4	4.1	3.9	3.7	3.4	3.2	3.0	2.8	2.6
47	52	4.9	4.6	4.4	4.1	3.9	3.7	3.4	3.2	3.0	2.8	2.6
48	53	4.9	4.6	4.4	4.1	3.9	3.6	3.4	3.2	3.0	2.8	2.6

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Male	Female	Ages										
		Male 87	88	89	90	91	92	93	94	95	96	97
		Female 92	93	94	95	96	97	98	99	100	101	102
49	54	4.9	4.6	4.3	4.1	3.9	3.6	3.4	3.2	3.0	2.8	2.6
50	55	4.8	4.6	4.3	4.1	3.9	3.6	3.4	3.2	3.0	2.8	2.6
51	56	4.8	4.6	4.3	4.1	3.8	3.6	3.4	3.2	3.0	2.8	2.6
52	57	4.8	4.5	4.3	4.1	3.8	3.6	3.4	3.2	3.0	2.8	2.6
53	58	4.8	4.5	4.3	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6
54	59	4.8	4.5	4.3	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6
55	60	4.7	4.5	4.3	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6
56	61	4.7	4.5	4.2	4.0	3.8	3.6	3.3	3.1	2.9	2.8	2.6
57	62	4.7	4.5	4.2	4.0	3.8	3.5	3.3	3.1	2.9	2.7	2.6
58	63	4.7	4.4	4.2	4.0	3.7	3.5	3.3	3.1	2.9	2.7	2.5
59	64	4.6	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.9	2.7	2.5

Male	Female	Ages										
		Male 98	99	100	101	102	103	104	105	106	107	108
		Female 103	104	105	106	107	108	109	110	111	112	113
35	40	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
36	41	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
37	42	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
38	43	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
39	44	2.4	2.3	2.1	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
40	45	2.4	2.2	2.1	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
41	46	2.4	2.2	2.1	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
42	47	2.4	2.2	2.0	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
43	48	2.4	2.2	2.0	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
44	49	2.4	2.2	2.0	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
45	50	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	0.8	0.7
46	51	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	0.8	0.7
47	52	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	0.8	0.7
48	53	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	0.8	0.7
49	54	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	0.8	0.7
50	55	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7
51	56	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7
52	57	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7
53	58	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7
54	59	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7
55	60	2.4	2.2	2.0	1.8	1.6	1.4	1.3	1.1	1.0	0.8	0.7
56	61	2.4	2.2	2.0	1.8	1.6	1.4	1.3	1.1	1.0	0.8	0.7
57	62	2.4	2.2	2.0	1.8	1.6	1.4	1.3	1.1	0.9	0.8	0.7
58	63	2.4	2.2	2.0	1.8	1.6	1.4	1.3	1.1	0.9	0.8	0.7
59	64	2.3	2.2	2.0	1.8	1.6	1.4	1.3	1.1	0.9	0.8	0.7

Male	Female	Ages										
		Male 87	88	89	90	91	92	93	94	95	96	97
		Female 92	93	94	95	96	97	98	99	100	101	102
60	65	4.6	4.4	4.1	3.9	3.7	3.5	3.3	3.1	2.9	2.7	2.5
61	66	4.6	4.3	4.1	3.9	3.7	3.5	3.3	3.1	2.9	2.7	2.5
62	67	4.5	4.3	4.1	3.9	3.7	3.5	3.3	3.1	2.9	2.7	2.5
63	68	4.5	4.3	4.1	3.8	3.6	3.4	3.2	3.0	2.9	2.7	2.5
64	69	4.5	4.2	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.7	2.5
65	70	4.4	4.2	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6	2.5
66	71	4.4	4.2	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6	2.4
67	72	4.3	4.1	3.9	3.7	3.5	3.3	3.1	3.0	2.8	2.6	2.4

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Male	Female	Ages										
		Male 87	88	89	90	91	92	93	94	95	96	97
		Female 92	93	94	95	96	97	98	99	100	101	102
68	73	4.3	4.1	3.9	3.7	3.5	3.3	3.1	2.9	2.8	2.6	2.4
69	74	4.2	4.0	3.8	3.6	3.5	3.3	3.1	2.9	2.7	2.6	2.4
70	75	4.2	4.0	3.8	3.6	3.4	3.2	3.1	2.9	2.7	2.5	2.4
71	76	4.1	3.9	3.8	3.6	3.4	3.2	3.0	2.9	2.7	2.5	2.3
72	77	4.1	3.9	3.7	3.5	3.3	3.2	3.0	2.8	2.7	2.5	2.3
73	78	4.0	3.8	3.7	3.5	3.3	3.1	3.0	2.8	2.6	2.5	2.3
74	79	3.9	3.8	3.6	3.4	3.3	3.1	2.9	2.8	2.6	2.4	2.3
75	80	3.9	3.7	3.5	3.4	3.2	3.0	2.9	2.7	2.6	2.4	2.2
76	81	3.8	3.6	3.5	3.3	3.2	3.0	2.8	2.7	2.5	2.4	2.2
77	82	3.7	3.6	3.4	3.3	3.1	3.0	2.8	2.6	2.5	2.3	2.2
78	83	3.7	3.5	3.4	3.2	3.1	2.9	2.7	2.6	2.4	2.3	2.1
79	84	3.6	3.4	3.3	3.1	3.0	2.8	2.7	2.5	2.4	2.2	2.1
80	85	3.5	3.4	3.2	3.1	2.9	2.8	2.6	2.5	2.3	2.2	2.0
81	86	3.4	3.3	3.1	3.0	2.9	2.7	2.6	2.4	2.3	2.1	2.0
82	87	3.3	3.2	3.1	2.9	2.8	2.7	2.5	2.4	2.2	2.1	2.0
83	88	3.2	3.1	3.0	2.9	2.7	2.6	2.5	2.3	2.2	2.0	1.9
84	89	3.1	3.0	2.9	2.8	2.7	2.5	2.4	2.3	2.1	2.0	1.9

Male	Female	Ages										
		Male 98	99	100	101	102	103	104	105	106	107	108
		Female 103	104	105	106	107	108	109	110	111	112	113
60	65	2.3	2.1	2.0	1.8	1.6	1.4	1.3	1.1	0.9	0.8	0.7
61	66	2.3	2.1	2.0	1.8	1.6	1.4	1.2	1.1	0.9	0.8	0.7
62	67	2.3	2.1	1.9	1.8	1.6	1.4	1.2	1.1	0.9	0.8	0.7
63	68	2.3	2.1	1.9	1.7	1.6	1.4	1.2	1.1	0.9	0.8	0.7
64	69	2.3	2.1	1.9	1.7	1.6	1.4	1.2	1.1	0.9	0.8	0.7
65	70	2.3	2.1	1.9	1.7	1.6	1.4	1.2	1.1	0.9	0.8	0.7
66	71	2.3	2.1	1.9	1.7	1.5	1.4	1.2	1.1	0.9	0.8	0.7
67	72	2.2	2.1	1.9	1.7	1.5	1.4	1.2	1.0	0.9	0.7	0.7
68	73	2.2	2.0	1.9	1.7	1.5	1.4	1.2	1.0	0.9	0.7	0.7
69	74	2.2	2.0	1.8	1.7	1.5	1.3	1.2	1.0	0.9	0.7	0.6
70	75	2.2	2.0	1.8	1.7	1.5	1.3	1.2	1.0	0.9	0.7	0.6
71	76	2.2	2.0	1.8	1.6	1.5	1.3	1.2	1.0	0.9	0.7	0.6
72	77	2.1	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7	0.6
73	78	2.1	1.9	1.8	1.6	1.4	1.3	1.1	1.0	0.8	0.7	0.6
74	79	2.1	1.9	1.7	1.6	1.4	1.3	1.1	1.0	0.8	0.7	0.6
75	80	2.1	1.9	1.7	1.6	1.4	1.3	1.1	1.0	0.8	0.7	.....
76	81	2.0	1.9	1.7	1.5	1.4	1.2	1.1	0.9	0.8	0.7	.....
77	82	2.0	1.8	1.7	1.5	1.4	1.2	1.1	0.9	0.8	0.7	.....
78	83	2.0	1.8	1.6	1.5	1.3	1.2	1.0	0.9	0.8	0.7	.....
79	84	1.9	1.8	1.6	1.5	1.3	1.2	1.0	0.9	0.8	0.7	.....
80	85	1.9	1.7	1.6	1.4	1.3	1.1	1.0	0.9	0.7	0.7	.....
81	86	1.8	1.7	1.5	1.4	1.3	1.1	1.0	0.8	0.7	0.6	.....
82	87	1.8	1.7	1.5	1.4	1.2	1.1	1.0	0.8	0.7	0.6	.....
83	88	1.8	1.6	1.5	1.3	1.2	1.1	0.9	0.8	0.7	0.6	.....
84	89	1.7	1.6	1.4	1.3	1.2	1.0	0.9	0.8	0.7	.....	.....

Male	Female	Ages									
		Male 87	88	89	90	91	92	93	94	95	96
		Female 92	93	94	95	96	97	98	99	100	101
85	90	3.1	2.9	2.8	2.7	2.6	2.5	2.3	2.2	2.1	1.9
86	91	3.0	2.8	2.7	2.6	2.5	2.4	2.3	2.1	2.0	1.9

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Male	Female	Ages									
		Male 87	88	89	90	91	92	93	94	95	96
		Female 92	93	94	95	96	97	98	99	100	101
87	92	2.9	2.8	2.6	2.5	2.4	2.3	2.2	2.1	1.9	1.8
88	93	2.8	2.7	2.6	2.4	2.3	2.2	2.1	2.0	1.9	1.7
89	94	2.6	2.6	2.5	2.4	2.2	2.1	2.0	1.9	1.8	1.7
90	95	2.5	2.4	2.4	2.3	2.2	2.0	1.9	1.8	1.7	1.6
91	96	2.4	2.3	2.2	2.2	2.1	2.0	1.9	1.7	1.6	1.5
92	97	2.3	2.2	2.1	2.0	2.0	1.9	1.8	1.7	1.6	1.5
93	98	2.2	2.1	2.0	1.9	1.9	1.8	1.7	1.6	1.5	1.4
94	99	2.1	2.0	1.9	1.8	1.7	1.7	1.6	1.5	1.4	1.3
95	100	1.9	1.9	1.8	1.7	1.6	1.6	1.5	1.4	1.3	1.2
96	101	1.8	1.7	1.7	1.6	1.5	1.5	1.4	1.3	1.2	1.1
97	102	1.7	1.6	1.6	1.5	1.4	1.4	1.3	1.2	1.1	1.1
98	103	1.6	1.5	1.4	1.4	1.3	1.3	1.2	1.1	1.0	1.0
99	104	1.4	1.4	1.3	1.3	1.2	1.1	1.1	1.0	1.0	0.9

Male	Female	Ages									
		Male 97	98	99	100	101	102	103	104	105	106
		Female 102	103	104	105	106	107	108	109	110	111
85	90	1.8	1.7	1.5	1.4	1.3	1.1	1.0	0.9	0.8	0.7
86	91	1.7	1.6	1.5	1.3	1.2	1.1	1.0	0.8	0.7	0.7
87	92	1.7	1.6	1.4	1.3	1.2	1.1	0.9	0.8	0.7	0.6
88	93	1.6	1.5	1.4	1.3	1.1	1.0	0.9	0.8	0.7	0.6
89	94	1.6	1.4	1.3	1.2	1.1	1.0	0.9	0.7	0.7	.....
90	95	1.5	1.4	1.3	1.2	1.0	0.9	0.8	0.7	0.6	.....
91	96	1.4	1.3	1.2	1.1	1.0	0.9	0.8	0.7	0.6	.....
92	97	1.4	1.3	1.1	1.0	0.9	0.8	0.7	0.7	.....	.....
93	98	1.3	1.2	1.1	1.0	0.9	0.8	0.7	0.6	.....	.....
94	99	1.2	1.1	1.0	0.9	0.8	0.7	0.7	.....	.....	.....
95	100	1.1	1.0	1.0	0.9	0.8	0.7	0.6	.....	.....	.....
96	101	1.1	1.0	0.9	0.8	0.7	0.7	.....	.....	.....	.....
97	102	1.0	0.9	0.8	0.7	0.7	0.6	.....	.....	.....	.....
98	103	0.9	0.8	0.7	0.7	0.6	.....	.....	.....	.....	.....
99	104	0.8	0.7	0.7	0.6	.....	.....	.....	.....	.....	.....

TABLE III.—PERCENT VALUE OF REFUND FEATURE

Ages		Duration of guaranteed amount—[Years]												
Male	Female	1	2	3	4	5	6	7	8	9	10	11	12	13
6	11									1	1	1	1	1
7	12									1	1	1	1	1
8	13								1	1	1	1	1	1
9	14								1	1	1	1	1	1
10	15								1	1	1	1	1	1
11	16								1	1	1	1	1	1
12	17								1	1	1	1	1	1
13	18								1	1	1	1	1	1
14	19								1	1	1	1	1	1
15	20								1	1	1	1	1	1
16	21								1	1	1	1	1	1
17	22								1	1	1	1	1	1
18	23								1	1	1	1	1	1
19	24								1	1	1	1	1	1
20	25								1	1	1	1	1	1
21	26								1	1	1	1	1	1

TABLE III.—PERCENT VALUE OF REFUND FEATURE—Continued

Ages		Duration of guaranteed amount—[Years]												
Male	Female	1	2	3	4	5	6	7	8	9	10	11	12	13
22	27							1	1	1	1	1	1	1
23	28							1	1	1	1	1	1	1
24	29							1	1	1	1	1	1	1
25	30							1	1	1	1	1	1	1
26	31						1	1	1	1	1	1	1	1
27	32						1	1	1	1	1	1	1	1
28	33						1	1	1	1	1	1	1	1
29	34						1	1	1	1	1	1	1	2
30	35					1	1	1	1	1	1	1	2	2
31	36					1	1	1	1	1	1	1	2	2
32	37					1	1	1	1	1	1	2	2	2
33	38				1	1	1	1	1	1	1	2	2	2
34	39				1	1	1	1	1	1	2	2	2	2
35	40				1	1	1	1	1	2	2	2	2	2
36	41				1	1	1	1	1	2	2	2	2	3
37	42			1	1	1	1	1	2	2	2	2	3	3
38	43			1	1	1	1	1	2	2	2	2	3	3
39	44			1	1	1	1	2	2	2	2	3	3	3
40	45			1	1	1	1	2	2	2	3	3	3	4
41	46			1	1	1	1	2	2	2	3	3	3	4
42	47			1	1	1	2	2	2	3	3	3	4	4
43	48		1	1	1	1	2	2	2	3	3	4	4	4
44	49		1	1	1	1	2	2	3	3	3	4	4	5
45	50		1	1	1	2	2	2	3	3	4	4	5	5
46	51		1	1	1	2	2	3	3	3	4	4	5	5
47	52		1	1	1	2	2	3	3	4	4	5	5	6
48	53		1	1	2	2	2	3	3	4	5	5	6	6
49	54		1	1	2	2	3	3	4	4	5	5	6	7
50	55		1	1	2	2	3	3	4	5	5	6	7	7
51	56		1	1	2	3	3	4	4	5	6	6	7	8
52	57	1	1	2	2	3	3	4	5	5	6	7	8	8
53	58	1	1	2	2	3	4	4	5	6	7	7	8	9
54	59	1	1	2	2	3	4	5	5	6	7	8	9	10
55	60	1	1	2	3	3	4	5	6	7	8	8	9	10
56	61	1	1	2	3	4	4	5	6	7	8	9	10	11
57	62	1	1	2	3	4	5	6	7	8	9	10	11	12
58	63	1	2	2	3	4	5	6	7	8	9	10	12	13
59	64	1	2	3	4	5	6	7	8	9	10	11	12	14
60	65	1	2	3	4	5	6	7	8	10	11	12	13	15
61	66	1	2	3	4	5	6	8	9	10	12	13	14	16
62	67	1	2	3	4	6	7	8	10	11	12	14	15	17
63	68	1	2	4	5	6	7	9	10	12	13	15	16	18
64	69	1	3	4	5	7	8	9	11	13	14	16	17	19
65	70	1	3	4	6	7	9	10	12	13	15	17	19	20
66	71	1	3	4	6	8	9	11	13	14	16	18	20	22
67	72	2	3	5	6	8	10	12	14	15	17	19	21	23
68	73	2	3	5	7	9	11	13	14	16	18	21	23	25
69	74	2	4	6	7	9	11	13	16	18	20	22	24	26
70	75	2	4	6	8	10	12	14	17	19	21	23	26	28
71	76	2	4	6	9	11	13	15	18	20	22	25	27	29
72	77	2	5	7	9	12	14	16	19	21	24	26	29	31
73	78	2	5	7	10	12	15	18	20	23	25	28	30	33
74	79	3	5	8	11	13	16	19	22	24	27	30	32	35
75	80	3	6	8	11	14	17	20	23	26	29	31	34	37
76	81	3	6	9	12	15	18	21	24	27	30	33	36	39
77	82	3	7	10	13	16	20	23	26	29	32	35	38	41
78	83	4	7	11	14	17	21	24	28	31	34	37	40	43
79	84	4	8	11	15	19	22	26	29	33	36	39	42	45

TABLE III.—PERCENT VALUE OF REFUND FEATURE—Continued

Ages		Duration of guaranteed amount—[Years]												
Male	Female	1	2	3	4	5	6	7	8	9	10	11	12	13
80	85	4	8	12	16	20	24	27	31	34	38	41	44	47
81	86	4	9	13	17	21	25	29	33	36	40	43	46	49
82	87	5	9	14	18	23	27	31	35	38	42	45	48	51
83	88	5	10	15	19	24	28	33	37	40	44	47	50	53
84	89	5	11	16	21	26	30	34	38	42	46	49	52	55
85	90	6	11	17	22	27	32	36	41	44	48	51	55	57

Ages		Duration of guaranteed amount—[Years]												
Male	Female	14	15	16	17	18	19	20	21	22	23	24	25	26
6	11	1	1	1	1	1	1	1	1	1	1	2	2	2
7	12	1	1	1	1	1	1	1	1	1	1	2	2	2
8	13	1	1	1	1	1	1	1	1	1	1	2	2	2
9	14	1	1	1	1	1	1	1	1	1	1	2	2	2
10	15	1	1	1	1	1	1	1	1	1	2	2	2	2
11	16	1	1	1	1	1	1	1	1	1	2	2	2	2
12	17	1	1	1	1	1	1	1	1	1	2	2	2	2
13	18	1	1	1	1	1	1	1	1	2	2	2	2	2
14	19	1	1	1	1	1	1	1	1	2	2	2	2	2
15	20	1	1	1	1	1	1	1	1	2	2	2	2	2
16	21	1	1	1	1	1	1	1	2	2	2	2	2	2
17	22	1	1	1	1	1	1	1	2	2	2	2	2	2
18	23	1	1	1	1	1	1	2	2	2	2	2	2	2
19	24	1	1	1	1	1	2	2	2	2	2	2	2	2
20	25	1	1	1	1	1	2	2	2	2	2	2	2	3
21	26	1	1	1	1	2	2	2	2	2	2	2	3	3
22	27	1	1	1	1	2	2	2	2	2	2	3	3	3
23	28	1	1	1	2	2	2	2	2	2	2	3	3	3
24	29	1	1	2	2	2	2	2	2	2	3	3	3	3
25	30	1	1	2	2	2	2	2	2	3	3	3	3	3
26	31	1	2	2	2	2	2	2	3	3	3	3	3	4
27	32	2	2	2	2	2	2	3	3	3	3	3	4	4
28	33	2	2	2	2	2	3	3	3	3	3	4	4	4
29	34	2	2	2	2	2	3	3	3	3	4	4	4	5
30	35	2	2	2	2	3	3	3	3	4	4	4	5	5
31	36	2	2	2	3	3	3	3	4	4	4	5	5	5
32	37	2	2	3	3	3	3	4	4	4	5	5	5	6
33	38	2	3	3	3	3	4	4	4	5	5	5	6	6
34	39	3	3	3	3	4	4	4	5	5	5	6	6	7
35	40	3	3	3	4	4	4	5	5	5	6	6	7	7
36	41	3	3	4	4	4	5	5	5	6	6	7	7	8
37	42	3	3	4	4	4	5	5	6	6	7	7	8	8
38	43	3	4	4	4	5	5	6	6	7	7	8	8	9
39	44	4	4	4	5	5	6	6	7	7	8	8	9	9
40	45	4	4	5	5	6	6	7	7	8	8	9	9	10
41	46	4	5	5	6	6	7	7	8	8	9	9	10	11
42	47	5	5	5	6	6	7	8	8	9	9	10	11	12
43	48		5	6	6	7	8	8	9	9	10	11	12	12
44	49	5	6	6	7	7	8	9	9	10	11	12	12	13
45	50	6	6	7	7	8	9	9	10	11	12	12	13	14

Ages		Duration of guaranteed amount—[Years]												
46	51	6	7	7	8	9	9	10	11	12	12	13	14	15
47	52	7	7	8	9	9	10	11	12	12	13	14	15	16
48	53	7	8	8	9	10	11	12	12	13	14	15	16	17
49	54	8	8	9	10	11	11	12	13	14	15	16	17	18
50	55	8	9	10	11	11	12	13	14	15	16	17	18	20

TABLE III.—PERCENT VALUE OF REFUND FEATURE—Continued

Ages		Duration of guaranteed amount—[Years]												
Male	Female	14	15	16	17	18	19	20	21	22	23	24	25	26
51	56	9	10	10	11	12	13	14	15	16	17	18	20	21
52	57	9	10	11	12	13	14	15	16	17	18	20	21	22
53	58	10	11	12	13	14	15	16	17	19	20	21	22	24
54	59	11	12	13	14	15	16	17	18	20	21	22	24	25
55	60	11	13	14	15	16	17	18	20	21	22	24	25	26
56	61	12	13	15	16	17	18	20	21	22	24	25	27	28
57	62	13	14	16	17	18	20	21	22	24	25	27	28	30
58	63	14	15	17	18	19	21	22	24	25	27	28	30	31
59	64	15	16	18	19	21	22	24	25	27	28	30	31	33
60	65	16	18	19	20	22	24	25	27	28	30	32	33	35
61	66	17	19	20	22	23	25	27	28	30	32	33	35	37
62	67	18	20	22	23	25	27	28	30	32	33	35	37	38
63	68	20	21	23	25	26	28	30	32	33	35	37	39	40
64	69	21	23	24	26	28	30	32	33	35	37	39	41	42
65	70	22	24	26	28	30	32	33	35	37	39	41	42	44
66	71	24	26	28	29	31	33	35	37	39	41	43	44	46
67	72	25	27	29	31	33	35	37	39	41	43	45	46	48
68	73	27	29	31	33	35	37	39	41	43	45	47	48	50
69	74	28	30	33	35	37	39	41	43	45	47	48	50	52
70	75	30	32	34	37	39	41	43	45	47	49	50	52	54
71	76	32	34	36	39	41	43	45	47	49	51	52	54	56
72	77	34	36	38	41	43	45	47	49	51	53	54	56	58
73	78	35	38	40	43	45	47	49	51	53	55	56	58	59
74	79	37	40	42	45	47	49	51	53	55	57	58	60	61
75	80	39	42	44	47	49	51	53	55	57	58	60	62	63
76	81	41	44	46	49	51	53	55	57	59	60	62	63	65
77	82	43	46	48	51	53	55	57	59	61	62	64	65	66
78	83	45	48	50	53	55	57	59	61	62	64	65	67	68
79	84	48	50	53	55	57	59	61	63	64	66	67	68	70
80	85	50	52	55	57	59	61	63	64	66	67	69	70	71
81	86	52	54	57	59	61	63	65	66	68	69	70	72	73
82	87	54	56	59	61	63	65	66	68	69	71	72	73	74
83	88	56	58	61	63	65	66	68	70	71	72	73	74	75
84	89	58	60	63	65	67	68	70	71	73	74	75	76	77
85	90	60	62	65	67	68	70	71	73	74	75	76	77	.....

Ages		Duration of guaranteed amount—[Years]								
Male	Female	27	28	29	30	31	32	33	34	35
6	11	2	2	2	2	2	2	2	2	2
7	12	2	2	2	2	2	2	2	2	3
8	13	2	2	2	2	2	2	2	2	3
9	14	2	2	2	2	2	2	2	3	3
10	15	2	2	2	2	2	2	3	3	3
11	16	2	2	2	2	2	2	3	3	3
12	17	2	2	2	2	2	3	3	3	3
13	18	2	2	2	2	2	3	3	3	3
14	19	2	2	2	2	3	3	3	3	3
15	20	2	2	2	3	3	3	3	3	3
16	21	2	2	3	3	3	3	3	3	4
17	22	2	2	3	3	3	3	3	4	4
18	23	2	3	3	3	3	3	4	4	4
19	24	3	3	3	3	3	4	4	4	4
20	25	3	3	3	3	4	4	4	4	5
21	26	3	3	3	4	4	4	4	5	5
22	27	3	3	4	4	4	4	5	5	5
23	28	3	3	4	4	4	5	5	5	5
24	29	3	4	4	4	5	5	5	5	6

TABLE III.—PERCENT VALUE OF REFUND FEATURE—Continued

Ages		Duration of guaranteed amount—[Years]								
Male	Female	27	28	29	30	31	32	33	34	35
25	30	4	4	4	5	5	5	6	6	6
26	31	4	4	5	5	5	6	6	6	7
27	32	4	5	5	5	6	6	6	7	7
28	33	5	5	5	6	6	6	7	7	8
29	34	5	5	6	6	6	7	7	8	8
30	35	5	6	6	6	7	7	8	8	9
31	36	6	6	6	7	7	8	8	9	9
32	37	6	7	7	7	8	8	9	10	10
33	38	7	7	7	8	8	9	10	10	11
34	39	7	8	8	9	9	10	10	11	12
35	40	8	8	9	9	10	10	11	12	12
36	41	8	9	9	10	10	11	12	13	13
37	42	9	9	10	11	11	12	13	13	14
38	43	9	10	11	11	12	13	13	14	15
39	44	10	11	11	12	13	14	14	15	16
40	45	11	11	12	13	14	15	15	16	17
41	46	11	12	13	14	15	16	16	17	18
42	47	12	13	14	15	16	17	18	18	19
43	48	13	14	15	16	17	18	19	20	21
44	49	14	15	16	17	18	19	20	21	22
45	50	15	16	17	18	19	20	21	22	23
46	51	16	17	18	19	20	21	22	24	25
47	52	17	18	19	20	21	23	24	25	26
48	53	18	19	20	22	23	24	25	26	28
49	54	19	21	22	23	24	25	27	28	29
50	55	21	22	23	24	26	27	28	29	31
51	56	22	23	25	26	27	28	30	31	32
52	57	23	25	26	27	29	30	31	33	34
53	58	25	26	28	29	30	32	33	34	36
54	59	26	28	29	31	32	33	35	36	38
55	60	28	29	31	32	34	35	36	38	39
56	61	29	31	32	34	35	37	38	40	41
57	62	31	33	34	36	37	39	40	41	43
58	63	33	34	36	37	39	40	42	43	45
59	64	35	36	38	39	41	42	44	45	47
60	65	36	38	40	41	43	44	46	47	48
61	66	38	40	41	43	44	46	47	49	50
62	67	40	42	43	45	46	48	49	51	52
63	68	42	44	45	47	48	50	51	52	54
64	69	44	46	47	49	50	52	53	54	55
65	70	46	47	49	50	52	53	55	56	57
66	71	48	49	51	52	54	55	56	58	59
67	72	50	51	53	54	56	57	58	59	61
68	73	52	53	55	56	57	59	60	61	62
69	74	53	55	56	58	59	60	62	63	64
70	75	55	57	58	60	61	62	62	64	65
71	76	57	59	60	61	63	64	65	66	67
72	77	59	60	62	63	64	65	66	67	68
73	78	61	62	64	65	66	67	68	69	70
74	79	63	64	65	66	67	68	69	70	71
75	80	64	66	67	68	69	70	71	72	72
76	81	66	67	68	69	70	71	72	73	
77	82	68	69	70	71	72	73	74		
78	83	69	70	71	72	73	74			
79	84	71	72	73	74	75				
80	85	72	73	74	75					
81	86	74	75	75						
82	87	75	76							
83	88	76								

TABLE III.—PERCENT VALUE OF REFUND FEATURE—Continued

Ages		Duration of guaranteed amount—[Years]								
Male	Female	27	28	29	30	31	32	33	34	35
84	89									
85	90									

Ages		Duration of guaranteed amount—[Years]													
Male	Female	1	2	3	4	5	6	7	8	9	10	11	12	13	14
86	91	6	12	18	24	29	34	38	43	47	50	54	57	59	62
87	92	7	13	19	25	31	36	40	45	49	52	56	59	61	64
88	93	7	14	21	27	32	38	42	47	51	55	58	61	63	66
89	94	8	15	22	28	34	40	45	49	53	57	60	63	65	68
90	95	8	16	23	30	36	42	47	51	55	59	62	65	67	70
91	96	9	17	25	32	38	44	49	53	57	61	64	67	69	71
92	97	9	18	26	34	40	46	51	55	59	63	66	69	71	73
93	98	10	20	28	36	42	48	53	58	62	65	68	70	73	75
94	99	11	21	30	37	44	50	55	60	64	67	70	72	74	76
95	100	12	22	31	39	46	52	58	62	66	69	72	74	76	78
96	101	12	24	33	42	49	55	60	64	68	71	73	76	78	79
97	102	13	25	35	44	51	57	62	66	70	73	75	77	79	
98	103	14	27	37	46	54	60	65	69	72	75	77	79		
99	104	15	29	40	49	56	62	67	71	74	77	79			
100	105	17	31	43	52	59	65	70	74	76	79				
101	106	18	33	46	55	63	68	73	76	79					
102	107	20	36	49	59	66	71	75	78						
103	108	22	40	53	62	69	74	78							
104	109	24	43	57	66	73	77								
105	110	27	48	61	70	76									
106	111		53	66	74										
107	112	35	53	71											
108	113	40	64												

Ages		Duration of guaranteed amount--[Years]										
Male	Female	15	16	17	18	19	20	21	22	23	24	25
86	91	64	66	68	70	72	73	74	75	76	77	
87	92	66	68	70	72	73	74	76	77	78		
88	93	68	70	72	73	75	76	77	78			
89	94	70	72	73	75	76	77	78				
90	95	72	73	75	76	77	79					
91	96	73	75	76	78	79						
92	97	75	76	78	79							
93	98	76	78	79								
94	99	78	79									
95	100	79										

TABLE IV.—TEMPORARY LIFE ANNUITIES [1]—ONE LIFE—EXPECTED RETURN MULTIPLES

Ages		Temporary period—maximum duration of annuity—[Years]									
Male	Female	1	2	3	4	5	6	7	8	9	10
0 to 8	0 to 13	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
9	14	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
10	15	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9

TABLE IV.—TEMPORARY LIFE ANNUITIES [1]—ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

Ages		Temporary period—maximum duration of annuity—[Years]									
Male	Female	1	2	3	4	5	6	7	8	9	10
11	16	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
12	17	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
13	18	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
14	19	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
15	20	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
16	21	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
17	22	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
18	23	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
19	24	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
20	25	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
21	26	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
22	27	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
23	28	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
24	29	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
25	30	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
26	31	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
27	32	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
28	33	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
29	34	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
30	35	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
31	36	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
32	37	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
33	38	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
34	39	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.9	9.8
35	40	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.9	9.8
36	41	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.9	9.8
37	42	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.8	9.8
38	43	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.8	9.8
39	44	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.9	8.8	9.8
40	45	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
41	46	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
42	47	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
43	48	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
44	49	1.0	2.0	3.0	4.0	4.9	5.9	6.8	7.8	8.7	9.7
45	50	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.8	8.7	9.6
46	51	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.8	8.7	9.6
47	52	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.7	8.7	9.6
48	53	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.7	8.6	9.5
49	54	1.0	2.0	3.0	3.9	4.9	5.8	6.8	7.7	8.6	9.5
50	55	1.0	2.0	3.0	3.9	4.9	5.8	6.8	7.7	8.6	9.5
51	56	1.0	2.0	3.0	3.9	4.9	5.8	6.7	7.7	8.6	9.4
52	57	1.0	2.0	3.0	3.9	4.9	5.8	6.7	7.6	8.5	9.4
53	58	1.0	2.0	2.9	3.9	4.9	5.8	6.7	7.6	8.5	9.3
54	59	1.0	2.0	2.9	3.9	4.8	5.8	6.7	7.6	8.4	9.3
55	60	1.0	2.0	2.9	3.9	4.8	5.8	6.7	7.5	8.4	9.2
56	61	1.0	2.0	2.9	3.9	4.8	5.7	6.6	7.5	8.4	9.2
57	62	1.0	2.0	2.9	3.9	4.8	5.7	6.6	7.5	8.3	9.1
58	63	1.0	2.0	2.9	3.9	4.8	5.7	6.6	7.4	8.3	9.1
59	64	1.0	2.0	2.9	3.9	4.8	5.7	6.5	7.4	8.2	9.0
60	65	1.0	2.0	2.9	3.8	4.8	5.6	6.5	7.3	8.1	8.9
61	66	1.0	2.0	2.9	3.8	4.7	5.6	6.5	7.3	8.1	8.8
62	67	1.0	2.0	2.9	3.8	4.7	5.6	6.4	7.2	8.0	8.8
63	68	1.0	2.0	2.9	3.8	4.7	5.6	6.4	7.2	7.9	8.7
64	69	1.0	1.9	2.9	3.8	4.7	5.5	6.3	7.1	7.9	8.6
65	70	1.0	1.9	2.9	3.8	4.6	5.5	6.3	7.1	7.8	8.5

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TABLE IV.—TEMPORARY LIFE ANNUITIES [1]—ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

Ages		Temporary period—maximum duration of annuity—[Years]									
Male	Female	1	2	3	4	5	6	7	8	9	10
66	71	1.0	1.9	2.9	3.8	4.6	5.4	6.2	7.0	7.7	8.4
67	72	1.0	1.9	2.9	3.7	4.6	5.4	6.2	6.9	7.6	8.3
68	73	1.0	1.9	2.8	3.7	4.6	5.4	6.1	6.8	7.5	8.2
69	74	1.0	1.9	2.8	3.7	4.5	5.3	6.1	6.8	7.4	8.0
70	75	1.0	1.9	2.8	3.7	4.5	5.3	6.0	6.7	7.3	7.9
71	76	1.0	1.9	2.8	3.7	4.5	5.2	5.9	6.6	7.2	7.8
72	77	1.0	1.9	2.8	3.6	4.4	5.2	5.8	6.5	7.1	7.6
73	78	1.0	1.9	2.8	3.6	4.4	5.1	5.8	6.4	7.0	7.5
74	79	1.0	1.9	2.8	3.6	4.3	5.0	5.7	6.3	6.8	7.3
75	80	1.0	1.9	2.7	3.5	4.3	5.0	5.6	6.2	6.7	7.1
76	81	1.0	1.9	2.7	3.5	4.2	4.9	5.5	6.1	6.5	7.0
77	82	1.0	1.9	2.7	3.5	4.2	4.8	5.4	5.9	6.4	6.8
78	83	1.0	1.9	2.7	3.4	4.1	4.7	5.3	5.8	6.2	6.6
79	84	1.0	1.8	2.7	3.4	4.1	4.7	5.2	5.7	6.1	6.4
80	85	1.0	1.8	2.6	3.4	4.0	4.6	5.1	5.5	5.9	6.2
81	86	1.0	1.8	2.6	3.3	3.9	4.5	5.0	5.4	5.7	6.0
82	87	1.0	1.8	2.6	3.3	3.9	4.4	4.8	5.2	5.6	5.8
83	88	.9	1.8	2.6	3.2	3.8	4.3	4.7	5.1	5.4	5.6
84	89	.9	1.8	2.5	3.2	3.7	4.2	4.6	4.9	5.2	5.4
85	90	.9	1.8	2.5	3.1	3.6	4.1	4.5	4.8	5.0	5.2
86	91	.9	1.8	2.5	3.1	3.6	4.0	4.3	4.6	4.8	5.0

Ages		Temporary period—maximum duration of annuity—[Years]									
Male	Female	11	12	13	14	15	16	17	18	19	20
0 to 8	0 to 13	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
9	14	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
10	15	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
11	16	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
12	17	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
13	18	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
14	19	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
15	20	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.7	19.7
16	21	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.8	18.7	19.7
17	22	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.8	18.7	19.7
18	23	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.8	18.7	19.7
19	24	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.7	18.7	19.7
20	25	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.7	18.7	19.7
21	26	10.9	11.9	12.9	13.8	14.8	15.8	16.8	17.7	18.7	19.6
22	27	10.9	11.9	12.9	13.8	14.8	15.8	16.7	17.7	18.7	19.6
23	28	10.9	11.9	12.9	13.8	14.8	15.8	16.7	17.7	18.7	19.6
24	29	10.9	11.9	12.9	13.8	14.8	15.8	16.7	17.7	18.6	19.6
25	30	10.9	11.9	12.8	13.8	14.8	15.7	16.7	17.7	18.6	19.6
26	31	10.9	11.9	12.8	13.8	14.8	15.7	16.7	17.6	18.6	19.5
27	32	10.9	11.9	12.8	13.8	14.8	15.7	16.7	17.6	18.6	19.5
28	33	10.9	11.8	12.8	13.8	14.7	15.7	16.6	17.6	18.5	19.5
29	34	10.9	11.8	12.8	13.8	14.7	15.7	16.6	17.6	18.5	19.4
30	35	10.9	11.8	12.8	13.7	14.7	15.6	16.6	17.5	18.4	19.4
31	36	10.8	11.8	12.8	13.7	14.7	15.6	16.5	17.5	18.4	19.3
32	37	10.8	11.8	12.7	13.7	14.6	15.6	16.5	17.4	18.4	19.3
33	38	10.8	11.8	12.7	13.7	14.6	15.6	16.5	17.4	18.3	19.2
34	39	10.8	11.8	12.7	13.6	14.6	15.5	16.4	17.4	18.3	19.2
35	40	10.8	11.7	12.7	13.6	14.6	15.5	16.4	17.3	18.2	19.1
36	41	10.8	11.7	12.7	13.6	14.5	15.4	16.3	17.2	18.1	19.0

TABLE IV.—TEMPORARY LIFE ANNUITIES [1]—ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

Ages		Temporary period—maximum duration of annuity—[Years]									
Male	Female	11	12	13	14	15	16	17	18	19	20
37	42	10.8	11.7	12.6	13.6	14.5	15.4	16.3	17.2	18.1	18.9
38	43	10.7	11.7	12.6	13.5	14.4	15.3	16.2	17.1	18.0	18.9
39	44	10.7	11.6	12.6	13.5	14.4	15.3	16.2	17.1	17.9	18.8
40	45	10.7	11.6	12.5	13.5	14.4	15.2	16.1	17.0	17.8	18.7
41	46	10.7	11.6	12.5	13.4	14.3	15.2	16.1	16.9	17.8	18.6
42	47	10.6	11.6	12.5	13.4	14.3	15.1	16.0	16.8	17.7	18.5
43	48	10.6	11.5	12.4	13.3	14.2	15.1	15.9	16.7	17.6	18.4
44	49	10.6	11.5	12.4	13.3	14.1	15.0	15.8	16.7	17.5	18.3
45	50	10.5	11.4	12.3	13.2	14.1	14.9	15.7	16.6	17.4	18.1
46	51	10.5	11.4	12.3	13.2	14.0	14.8	15.7	16.5	17.2	18.0
47	52	10.5	11.4	12.2	13.1	13.9	14.7	15.6	16.3	17.1	17.8
48	53	10.4	11.3	12.2	13.0	13.8	14.7	15.4	16.2	17.0	17.7
49	54	10.4	11.3	12.1	12.9	13.8	14.6	15.3	16.1	16.8	17.5
50	55	10.3	11.2	12.0	12.9	13.7	14.5	15.2	16.0	16.7	17.4
51	56	10.3	11.1	12.0	12.8	13.6	14.3	15.1	15.8	16.5	17.2
52	57	10.2	11.1	11.9	12.7	13.5	14.2	14.9	15.6	16.3	17.0
53	58	10.2	11.0	11.8	12.6	13.4	14.1	14.8	15.5	16.1	16.8
54	59	10.1	10.9	11.7	12.5	13.2	14.0	14.6	15.3	15.9	16.5
55	60	10.1	10.9	11.6	12.4	13.1	13.8	14.5	15.1	15.7	16.3
56	61	10.0	10.8	11.5	12.3	13.0	13.7	14.3	14.9	15.5	16.1
57	62	9.9	10.7	11.4	12.2	12.8	13.5	14.1	14.7	15.3	15.8
58	63	9.8	10.6	11.3	12.0	12.7	13.3	13.9	14.5	15.0	15.5
59	64	9.8	10.5	11.2	11.9	12.5	13.2	13.7	14.3	14.8	15.3
60	65	9.7	10.4	11.1	11.7	12.4	13.0	13.5	14.0	14.5	15.0
61	66	9.6	10.3	11.0	11.6	12.2	12.8	13.3	13.8	14.2	14.7
62	67	9.5	10.2	10.8	11.4	12.0	12.5	13.1	13.5	14.0	14.3
63	68	9.4	10.0	10.7	11.3	11.8	12.3	12.8	13.2	13.7	14.0
64	69	9.3	9.9	10.5	11.1	11.6	12.1	12.5	13.0	13.3	13.7
65	70	9.1	9.8	10.3	10.9	11.4	11.9	12.3	12.7	13.0	13.3
66	71	9.0	9.6	10.2	10.7	11.2	11.6	12.0	12.4	12.7	13.0
67	72	8.9	9.5	10.0	10.5	10.9	11.3	11.7	12.0	12.3	12.6
68	73	8.7	9.3	9.8	10.3	10.7	11.1	11.4	11.7	12.0	12.2
69	74	8.6	9.1	9.6	10.0	10.4	10.8	11.1	11.4	11.6	11.8
70	75	8.4	8.9	9.4	9.8	10.2	10.5	10.8	11.0	11.2	11.4
71	76	8.3	8.7	9.2	9.6	9.9	10.2	10.4	10.7	10.9	11.0
72	77	8.1	8.6	8.9	9.3	9.6	9.9	10.1	10.3	10.5	10.6
73	78	7.9	8.3	8.7	9.0	9.3	9.6	9.8	9.9	10.1	10.2
74	79	7.7	8.1	8.5	8.8	9.0	9.2	9.4	9.6	9.7	9.8
75	80	7.6	7.9	8.2	8.5	8.7	8.9	9.1	9.2	9.3	9.4
76	81	7.4	7.7	8.0	8.2	8.4	8.6	8.7	8.8	8.9	9.0
77	82	7.1	7.5	7.7	7.9	8.1	8.3	8.4	8.5	8.5	8.6
78	83	6.9	7.2	7.4	7.6	7.8	7.9	8.0	8.1	8.2	8.2
79	84	6.7	7.0	7.2	7.3	7.5	7.6	7.7	7.7	7.8	7.8
80	85	6.5	6.7	6.9	7.1	7.2	7.3	7.3	7.4	7.4	7.4
81	86	6.3	6.5	6.6	6.8	6.9	6.9	7.0	7.0	7.1	
82	87	6.0	6.2	6.4	6.5	6.5	6.6	6.7	6.7		
83	88	5.8	6.0	6.1	6.2	6.2	6.3	6.3			
84	89	5.6	5.7	5.8	5.9	5.9	6.0				
85	90	5.3	5.5	5.5	5.6	5.6					
86	91	5.1	5.2	5.3	5.3						

Ages		Temporary period—maximum duration of annuity—[Years]									
Male	Female	21	22	23	24	25	26	27	28	29	30
0 to 8	0 to 13	20.7	21.7	22.7	23.6	24.6	25.6	26.5	27.5	28.4	29.4
9	14	20.7	21.7	22.7	23.6	24.6	25.5	26.5	27.5	28.4	29.4
10	15	20.7	21.7	22.7	23.6	24.6	25.5	26.5	27.5	28.4	29.4
11	16	20.7	21.7	22.6	23.6	24.6	25.5	26.5	27.4	28.4	29.3

TABLE IV.—TEMPORARY LIFE ANNUITIES [1]—ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

Ages		Temporary period—maximum duration of annuity—[Years]									
Male	Female	21	22	23	24	25	26	27	28	29	30
12	17	20.7	21.7	22.6	23.6	24.6	25.5	26.5	27.4	28.4	29.3
13	18	20.7	21.7	22.6	23.6	24.6	25.5	26.5	27.4	28.4	29.3
14	19	20.7	21.7	22.6	23.6	24.5	25.5	26.4	27.4	28.3	29.3
15	20	20.7	21.6	22.6	23.6	24.5	25.5	26.4	27.4	28.3	29.2
16	21	20.7	21.6	22.6	23.6	24.5	25.5	26.4	27.3	28.3	29.2
17	22	20.7	21.6	22.6	23.5	24.5	25.4	26.4	27.3	28.2	29.2
18	23	20.7	21.6	22.6	23.5	24.5	25.4	26.3	27.3	28.2	29.1
19	24	20.6	21.6	22.5	23.5	24.4	25.4	26.3	27.2	28.1	29.1
20	25	20.6	21.6	22.5	23.5	24.4	25.3	26.3	27.2	28.1	29.0
21	26	20.6	21.5	22.5	23.4	24.4	25.3	26.2	27.1	28.0	28.9
22	27	20.6	21.5	22.5	23.4	24.3	25.3	26.2	27.1	28.0	28.9
23	28	20.6	21.5	22.4	23.4	24.3	25.2	26.1	27.0	27.9	28.8
24	29	20.5	21.5	22.4	23.3	24.2	25.2	26.1	27.0	27.8	28.7
25	30	20.5	21.4	22.4	23.3	24.2	25.1	26.0	26.9	27.8	28.6
26	31	20.5	21.4	22.3	23.2	24.1	25.0	25.9	26.8	27.7	28.5
27	32	20.4	21.3	22.3	23.2	24.1	25.0	25.8	26.7	27.6	28.4
28	33	20.4	21.3	22.2	23.1	24.0	24.9	25.8	26.6	27.5	28.3
29	34	20.3	21.2	22.1	23.0	23.9	24.8	25.7	26.5	27.4	28.2
30	35	20.3	21.2	22.1	23.0	23.8	24.7	25.6	26.4	27.2	28.1
31	36	20.2	21.1	22.0	22.9	23.8	24.6	25.5	26.3	27.1	27.9
32	37	20.2	21.1	21.9	22.8	23.7	24.5	25.4	26.2	27.0	27.8
33	38	20.1	21.0	21.9	22.7	23.6	24.4	25.2	26.0	26.8	27.6
34	39	20.0	20.9	21.8	22.6	23.5	24.3	25.1	25.9	26.7	27.4
35	40	20.0	20.8	21.7	22.5	23.3	24.2	25.0	25.7	26.5	27.2
36	41	19.9	20.7	21.6	22.4	23.2	24.0	24.8	25.6	26.3	27.0
37	42	19.8	20.6	21.5	22.3	23.1	23.9	24.6	25.4	26.1	26.8
38	43	19.7	20.5	21.4	22.2	23.0	23.7	24.5	25.2	25.9	26.6
39	44	19.6	20.4	21.2	22.0	22.8	23.6	24.3	25.0	25.7	26.4
40	45	19.5	20.3	21.1	21.9	22.6	23.4	24.1	24.8	25.5	26.1
41	46	19.4	20.2	21.0	21.7	22.5	23.2	23.9	24.6	25.2	25.9
42	47	19.3	20.1	20.8	21.6	22.3	23.0	23.7	24.3	25.0	25.6
43	48	19.2	19.9	20.7	21.4	22.1	22.8	23.4	24.1	24.7	25.3
44	49	19.0	19.8	20.5	21.2	21.9	22.6	23.2	23.8	24.4	25.0
45	50	18.9	19.6	20.3	21.0	21.7	22.3	22.9	23.5	24.1	24.6
46	51	18.7	19.4	20.1	20.8	21.5	22.1	22.7	23.2	23.8	24.3
47	52	18.6	19.3	19.9	20.6	21.2	21.8	22.4	22.9	23.4	23.9
48	53	18.4	19.1	19.7	20.4	21.0	21.5	22.1	22.6	23.1	23.5
49	54	18.2	18.9	19.5	20.1	20.7	21.2	21.7	22.2	22.7	23.1
50	55	18.0	18.7	19.3	19.8	20.4	20.9	21.4	21.9	22.3	22.7
51	56	17.8	18.4	19.0	19.6	20.1	20.6	21.1	21.5	21.9	22.3
52	57	17.6	18.2	18.7	19.3	19.8	20.2	20.7	21.1	21.5	21.8
53	58	17.4	17.9	18.5	19.0	19.4	19.9	20.3	20.7	21.0	21.3
54	59	17.1	17.7	18.2	18.7	19.1	19.5	19.9	20.2	20.6	20.8
55	60	16.9	17.4	17.9	18.3	18.7	19.1	19.5	19.8	20.1	20.3
56	61	16.6	17.1	17.5	18.0	18.4	18.7	19.0	19.3	19.6	19.8
57	62	16.3	16.8	17.2	17.6	18.0	18.3	18.6	18.9	19.1	19.3
58	63	16.0	16.5	16.9	17.2	17.6	17.9	18.1	18.4	18.6	18.8
59	64	15.7	16.1	16.5	16.8	17.1	17.4	17.7	17.9	18.1	18.2
60	65	15.4	15.8	16.1	16.4	16.7	17.0	17.2	17.4	17.5	17.7
61	66	15.1	15.4	15.7	16.0	16.3	16.5	16.7	16.9	17.0	17.1
62	67	14.7	15.0	15.3	15.6	15.8	16.0	16.2	16.3	16.4	16.5
63	68	14.4	14.6	14.9	15.1	15.3	15.5	15.7	15.8	15.9	16.0
64	69	14.0	14.3	14.5	14.7	14.9	15.0	15.2	15.3	15.3	15.4
65	70	13.6	13.8	14.1	14.2	14.4	14.5	14.6	14.7	14.8	14.9
66	71	13.2	13.4	13.6	13.8	13.9	14.0	14.1	14.2	14.2	14.3
67	72	12.8	13.0	13.2	13.3	13.4	13.5	13.6	13.7	13.7	13.7
68	73	12.4	12.6	12.7	12.8	12.9	13.0	13.1	13.1	13.2	13.2
69	74	12.0	12.1	12.3	12.4	12.4	12.5	12.6	12.6	12.6	12.6
70	75	11.6	11.7	11.8	11.9	12.0	12.0	12.0	12.1	12.1	12.1

TABLE IV.—TEMPORARY LIFE ANNUITIES [1]—ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

Ages		Temporary period—maximum duration of annuity—[Years]									
Male	Female	21	22	23	24	25	26	27	28	29	30
71	76	11.2	11.3	11.3	11.4	11.5	11.5	11.5	11.6	11.6	
72	77	10.7	10.8	10.9	10.9	11.0	11.0	11.0	11.0		
73	78	10.3	10.4	10.4	10.5	10.5	10.5	10.5			
74	79	9.9	9.9	10.0	10.0	10.1	10.1				
75	80	9.5	9.5	9.6	9.6	9.6					
76	81	9.1	9.1	9.1	9.1						
77	82	8.6	8.7	8.7							
78	83	8.2	8.3								
79	84	7.8									

[1] The multiples in this table are not applicable to annuities for a term certain; for such cases see paragraph (c) of § 1.72-5.

If the terms of the contract (a) involve a life or lives, (b) are such that the above tables cannot be correctly applied, and (c) the amounts received thereunder are at least partly "amounts received as an annuity" under a contract to which section 72 applies, the taxpayer may submit with his return an actuarial computation based upon the 1937 Standard Annuity Table with ages set back one year, showing the appropriate factors applied in his case, subject to the approval of the Commissioner upon examination of such return. Computations involving factors to compensate for the effects of contingencies other than mortality, such as marriage or remarriage, re-employment, recovery from disability, or the like, will not be approved.

§ 1.72-10 Effect of transfer of contracts on investment in the contract.

(a) If a contract to which section 72 applies, or any interest therein, is transferred for a valuable consideration, by assignment or otherwise, only the actual value of the consideration given for such transfer and the amount of premiums or other consideration subsequently paid by the transferee shall be included in the transferee's aggregate of premiums or other consideration paid. In accordance with the provisions of section 72(g)(3) and paragraph (b) of § 1.72-4, an annuity starting date shall be determined for the transferee without regard to the annuity starting date, if any, of the transferor. In determining the transferee's investment in the contract, the aggregate amount of premiums or other consideration paid shall be reduced by all amounts received by the transferee before the receipt of an amount as an annuity or before the annuity starting date, whichever is the later, to the extent that such amounts were excludable from his gross income under the applicable income tax law at the time of receipt. For the treatment of amounts received by the transferee subsequent to both the annuity starting date and the date of receipt of a payment as an annuity, but not received as annuity payments, see § 1.72-11. For a limitation on adjustments to the basis of annuity contracts sold, see section 1021.

(b) In the case of a transfer of such a contract without valuable consideration, the annuity starting date and the expected return under the contract shall be determined as though no such transfer had taken place. See paragraph (b) of § 1.72-4. The transferee shall include the aggregate of premiums or other consideration paid or deemed to have been paid by his transferor in the aggregate of premiums or other consideration as though paid by him. In determining the transferee's investment in the contract, the transferee's aggregate amount of premiums or other consideration paid (as so found) shall be reduced by all amounts either received or deemed to have been received by himself or his transferor before the annuity starting date, or before the date on which an amount is first received as an annuity, whichever is the later, to the extent that such amounts were excludable from the gross income of the actual recipient under the applicable income tax law at the time of receipt. For treatment of amounts received subsequent to both the above dates by such

transferee, but not received as annuity payments, see § 1.72-11.

§ 1.72-11 Amounts not received as annuity payments.

(a) *Introductory.* (1) This section applies to amounts received under a contract to which section 72 applies if either:

(i) Paragraph (b) of § 1.72-2 is inapplicable to such amounts.

(ii) Paragraph (b) of § 1.72-2 is applicable but the annuity payments received differ either in amount, duration, or both, from those originally provided under the contract, or

(iii) Paragraph (b) of § 1.72 is applicable, but such annuity payments are received by a beneficiary after the death of an annuitant (or annuitants) in full discharge of the obligation under the contract and solely because of a guarantee.

The payments referred to in subdivision (i) of this subparagraph include all amounts other than "amounts received as an annuity" as that term is defined in paragraph (b) (2) and (3) of § 1.72-2. If such amounts are received as dividends or payments in the nature of dividends, or as a return of premiums, see paragraph (b) of this section. If such amounts are paid in full discharge of the obligation under the contract and are in the nature of a refund of the consideration, see paragraph (c) of this section. If such amounts are paid upon the surrender, redemption, or maturity of the contract, see paragraph (d) of this section. The payments referred to in subdivision (ii) of this subparagraph include all annuity payments which are paid as the result of a modification or an exchange of the annuity obligations originally provided under a contract for different annuity obligations (whether or not such modification or exchange is accompanied by the payment of an amount to which subdivision (i) of this subparagraph applies). If the duration of the new annuity obligations differs from the duration of the old annuity obligations, paragraph (e) of this section applies to the new annuity obligations and paragraph (d) of this section applies to any lump sum payment received. If, however, the duration of the new annuity obligations is the same as the duration of the old obligations, paragraph (f) of this section applies to the new obligations and to any lump sum received in connection therewith. The annuity payments referred to in subdivision (iii) of this subparagraph are annuity payments which are made to a beneficiary after the death of annuitant (or annuitants) in full discharge of the obligations under a contract because of a provision in the contract requiring the payment of a guaranteed amount or minimum number of payments for a fixed period; see paragraph (c) of this section.

(2) The principles of this section apply, to the extent appropriate thereto, to amounts paid which are taxable under section 72 (except, for taxable years beginning before January 1, 1964, section 72(e)(3)) in accordance with sections 402 and 403 and the regulations thereunder. However, if contributions used to purchase the contract include amounts for which a deduction was allowed under section 404 as contributions on behalf of an owner-employee, the rules of this section are modified by the rules of paragraph (b) of § 1.72-17. Further, in applying the provisions of this section, the aggregate premiums or other consideration paid shall not include contributions on behalf of self-employed individuals to the extent that deductions were allowed under section 404 for such contributions. Nor, shall the aggregate of premiums or other consideration paid include amounts used to purchase life, accident, health, or other insurance protection for an owner-employee. See paragraph (b)(4) of § 1.72-16 and paragraph (c) of § 1.72-17. The principles of this section also apply to payments made in the manner described in paragraph (b)(3)(i) of § 1.72-2.

(b) *Amounts received in the nature of dividends or similar distributions.* (1) If dividends (or payments in the nature of dividends or a return of premiums or other consideration) are received under a contract to which section 72 applies and such payments are received before the annuity starting date or before the date on which an amount is first received as an annuity, whichever is the later, such payments

are includible in the gross income of the recipient only to the extent that they, taken together with all previous payments received under the contract which were excludable from the gross income of the recipient under the applicable income tax law, exceed the aggregate of premiums or other consideration paid or deemed to have been paid by the recipient. Such payments shall also be subtracted from the consideration paid (or deemed paid) both for the purpose of determining an exclusion ratio to be applied to subsequent amounts paid as an annuity and for the purpose of determining the applicability of section 72(d) and § 1.72-13, relating to employee contributions recoverable in three years.

(2) If dividends or payments in the nature of dividends are paid under a contract to which section 72 applies and such payments are received on or after the annuity starting date or the date on which an amount is first received as an annuity, whichever is later, such payments shall be fully includible in the gross income of the recipient. The receipt of such payments shall not affect the aggregate of premiums or other consideration paid nor the amounts contributed or deemed to have been contributed by an employee as otherwise calculated for purposes of section 72. Since the investment in the contract and the expected return are not affected by a payment which is fully includible in the gross income of the recipient under this rule, the exclusion ratio will not be affected by such payment and will continue to be applied to amounts received as annuity payments in the future as though such payment had not been made. This subparagraph shall apply to amounts received under a contract described in paragraph (b)(3)(i) of § 1.72-2 to the extent that the amounts received exceed the portion of the investment in the contract allocable to each taxable year in accordance with paragraph (d)(3) of § 1.72-4. Hence, such excess is fully includible in the gross income of the recipient.

(c) *Amounts received in the nature of a refund of the consideration under a contract and in full discharge of the obligation thereof.* (1) Any amount received under a contract to which section 72 applies, if it is at least in part a refund of the consideration paid, including amounts payable to a beneficiary after the death of an annuitant by reason of a provision in the contract for a life annuity with minimum period of payments certain or with a minimum amount which must be paid in any event, shall be considered an amount received in the nature of a refund of the consideration paid for such contract. If such an amount is in full discharge of an obligation to pay a fixed amount (whether in a lump sum or otherwise) or to pay amounts for a fixed number of years (including amounts described in paragraph (b)(3)(i) of § 1.72-2), it shall be included in the gross income of the recipient only to the extent that it, when added to amounts previously received under the contract which were excludable from gross income under the law applicable at the time of receipt, exceeds the aggregate of premiums or other consideration paid. See section 72(e)(2)(A). This paragraph shall not apply if the total of the amounts to be paid in discharge of the obligation can in any event exceed the total of the annuity payments which would otherwise fully discharge the obligation. For rules to be applied in such a case, see paragraph (e) of this section.

(2) The principles of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). A, a male employee, retired on December 31, 1954, at the age of 60. A life annuity of $75 per month was payable to him beginning January 31, 1955. The annuity contract guaranteed that if A did not live at least ten years, his beneficiary, B, would receive the monthly payments for any balance of the first ten years after A's retirement which remained at the date of A's death. Under section 72, A was deemed to have paid $3,600 toward the cost of the annuity. A lived for five years, receiving a total of $4,500 in annuity payments. After A's death, B began receiving the monthly payments of $75 beginning with the January 31, 1960, payment. B will exclude such payments from his gross income throughout 1960, 1961, and 1962, and will exclude only $18 of the first payment in 1963 from his gross income for that year. Thereafter, B will include the entire amount of all such payments in his gross income for the taxable year of receipt. This result is determined as follows:

A's investment in the contract (unadjusted)	$3,600
Multiple from Table III of § 1.72-9 for male, age 60, where duration of guaranteed amount is 10 years (percent)	11
Subtract value of the refund feature to the nearest dollar (11 percent of $3,600)	396
Investment in the contract adjusted for the present value of the refund feature without discount for interest	3,204
Aggregate of premiums or other consideration paid	3,600
A's exclusion ratio ($3,204 ÷ $16,380 [$900 × 18.2]) (percent)	19.6
Subtract amount excludable during five years A received payments (19.6 percent of $4,500 [$900 × 5])	882
Remainder of aggregate of premiums or other consideration paid excludable from gross income of B under section 72 (e)	2,718

As a result of the above computation, the number of payments to B which will exhaust the remainder of consideration paid which is excludable from gross income of the recipient is 36⅔₅ ($2,718 ÷ $75) and B will exclude the payments from his gross income for three years, then exclude only $18 of the first payment for the fourth year from his gross income, and thereafter include the entire amount of all payments he receives in his gross income.

Example (2). The facts are the same as in example (1), except that B, the beneficiary, elects to receive $50 per month for his life in lieu of the payments guaranteed under the original contractual obligation. Since such amounts will be received as an annuity and may, because of the length of time B may live, exceed the amount guaranteed, they are not amounts to which this paragraph applies. See paragraph (e) of this section.

Example (3). The facts are the same as in example (1), except that B, the beneficiary, elects to receive the remaining guaranteed amount in installments which are larger or smaller than the $75 per month provided until, under the terms of the contract, the guaranteed amount is exhausted. The rule of subparagraph (1) of this paragraph and the computation illustrated in example (1) apply to such installments since the total of such installments will not exceed the original amount guaranteed to be paid at A's death in any event.

Example (4). C pays $12,000 for a contract providing that he is to be paid an annuity of $1,000 per year for 15 years. His exclusion ratio is therefore 80 percent ($12,000 ÷ $15,000). He directs that the annuity is to be paid to D, his beneficiary, if he should die before the full 15 year period has expired. C dies after 5 years and D is paid $1,000 in 1960. D will include $200 ($1,000 − $800 [80 percent of $1,000]) in his gross income for the taxable year in which he receives the $1,000 since section 72(e) and this section do not apply to the annuity payments made in accordance with the provisions and during the term of the contract. D will continue with the same exclusion ratio used by C (80 percent).

Example (5). In 1954, E paid $50,000 into a fund and was promised an annual income for life the amount of which would depend in part upon the earnings realized from the investment of the fund in accordance with an agreed formula. The contract also specified that if E should die before ten years had elapsed, his beneficiary, F, would be paid the amounts determined annually under the formula until ten payments had been realized by E and F together. E died in 1960, having received five payments totaling $30,000. Assuming that $22,000 of this amount was properly excludable from E's gross income prior to his death, F will exclude from his gross income the payments he receives until the taxable year in which his total receipts from the fund exceeds $28,000 ($50,000 − $22,000). F will include any excess over the $28,000 in his gross income for that taxable year. Thereafter, F will include in his gross income the entire amount of any payments made to him from the fund.

(3) For the purpose of applying the rule contained in subparagraph (1) of this paragraph, it is immaterial whether the recipient of the amount received in full discharge of the obligation is the same person as the recipient of amounts previously received under the contract which were excludable from gross income, except in the case of a contract transferred for a valuable consideration, with respect to which see paragraph (a) of § 1.72-10. For the limit on the tax, for taxable years beginning before January 1, 1964, attributable to the receipt of a lump sum to which this paragraph applies, see paragraph (g) of this section.

(d) *Amounts received upon the surrender, redemption, or maturity of a contract.* (1) Any amount received upon the surrender, redemption, or maturity of a contract to which section 72 applies, which is not received as an annuity under the regulations of paragraph (b) of § 1.72-2, shall be included in the gross income of the recipient to the extent that it, when added to amounts previously received under the contract and which were excludable from the gross income of the recipient under the law applicable at the time of receipt, exceeds the aggregate of premiums or other consideration paid. See section 72(e)(2)(B). If

amounts are to be received as an annuity, whether in lieu of or in addition to amounts described in the preceding sentence, such amounts shall be included in the gross income of the recipient in accordance with the provisions of paragraph (e) or (f) of this section, whichever is applicable. The rule stated in the first sentence of this paragraph shall not apply to payments received as an annuity or otherwise after the date of the first receipt of an amount as an annuity subsequent to the maturity, redemption, or surrender of the original contract. If amounts are so received and are other than amounts received as an annuity, they are includible in the gross income of the recipient. See section 72(e)(1)(A) and paragraph (b)(2) of this section.

(2) For the purpose of applying the rule contained in subparagraph (1) of this paragraph, it is immaterial whether the recipient of the amount received upon the surrender, redemption, or maturity of the contract is the same as the recipient of amounts previously received under the contract which were excludable from gross income, except in the case of a contract transferred for a valuable consideration, with respect to which see paragraph (a) of § 1.72-10. For the limit on the amount of tax, for taxable years beginning before January 1, 1964, attributable to the receipt of certain lump sums to which this paragraph applies, see paragraph (g) of this section.

(e) *Periodic payments received for a different term.* If, after the date on which an amount is first received as an annuity under a contract to which section 72 applies, the terms of the contract are modified or the annuity obligations are exchanged so that periodic payments are to be received for a different term than originally provided under the contract (whether or not accompanied by the receipt of a lump sum to which paragraph (d) of this section applies), the rules of this paragraph shall apply to such payments. Hence, the provisions of section 72(e) and paragraphs (b), (c), (d), and (f) of this section are inapplicable for the purpose of determining the includibility of such payments in gross income and the general principles of section 72 with respect to the use of an exclusion ratio shall be applied to such payments as if they were provided under a new contract received in exchange for the contract providing the original annuity payments. If such payments are received as the result of the surrender, redemption, or discharge of a contract to which section 72 applies, they shall be considered to be received as an annuity under a contract exchanged for the contract whose redemption, surrender, or discharge was involved. For the purpose of determining the extent to which the payments so received are to be included in the gross income of the recipient, an exclusion ratio shall be determined for such contract as of the later of January 1, 1954, or the first day of the first period for which an amount is received as an annuity thereunder, whichever is the later. See paragraph (b) of § 1.72-4. In determining the investment in the contract for this purpose, any lump sum amount received at the time of the exchange shall not be considered an amount to which paragraph (a)(2) of § 1.72-6 applies. However, such lump sum shall be subtracted from the aggregate of premiums or other consideration paid to the extent it is excludable as an amount not received as an annuity under this section as if it were an amount received before the annuity starting date of the contract obtained in exchange.

(f) *Periodic payments received for the same term after a lump sum withdrawal.* (1) If, after the date of the first receipt of a payment as an annuity, the annuitant receives a lump sum and is thereafter to receive annuity payments in a reduced amount under the contract for the same term, life, or lives as originally specified in the contract, a portion of the contract shall be considered to have been surrendered or redeemed in consideration of the payment of such lump sum and the exclusion ratio originally determined for the contract shall continue to apply to the amounts received as an annuity without regard to the fact that such amounts are less than the original amounts which were to be paid periodically. The lump sum shall

be includible in the gross income of the recipient in accordance with the provisions of subparagraph (2) of this paragraph. However, except in the case of amounts to which sections 402 and 403 apply, the tax, for taxable years beginning before January 1, 1964, attributable to the inclusion of all or part of the lump sum in gross income shall not exceed the amount determined under section 72(e)(3) and paragraph (g) of this section. For taxable years beginning after December 31, 1963, such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(2) There shall be excluded from gross income that portion of the lump sum which bears the same ratio to the aggregate premiums or other consideration paid for the contract, as reduced by all amounts previously received under the contract and excludable from the gross income of the recipient under the applicable income tax law, as:

(i) In the case of payments to be made in the manner described in paragraph (b)(2) of § 1.72-2, the amount of the reduction in the annuity payments to be made thereafter bears to the annuity payments originally provided under the contract, or

(ii) In the case of a contract providing for payments to be made in the manner described in paragraph (b)(3)(i) of § 1.72-2, the amount of the reduction in the number of units per period to be paid thereafter bears to the number of units per period payable under the contract immediately before the lump sum withdrawal.

(3) This paragraph may be illustrated by the following examples:

Example (1). Taxpayer A pays $20,000 for an annuity contract providing for payments to him of $100 per month for his life. At the annuity starting date he has a life expectancy of 20 years. His expected return is therefore $24,000 and the exclusion ratio is five-sixths. He continues to receive the original annuity payments for 5 years, receiving a total of $6,000, and properly excludes a total of $5,000 from his gross income in his income tax returns for those years. At the beginning of the next year, A agrees with the insurer to take a reduced annuity of $75 per month and a lump sum payment of $4,000 in cash. Of the lump sum he receives, he will include $250 and exclude $3,750 from his gross income for his taxable year of receipt, determined as follows:

Aggregate of premiums or other consideration paid	$20,000
Less amounts received as an annuity to the extent they were excludable from A's income	$5,000
Remainder of the consideration	$15,000
Ratio of the reduction in the amount of the annuity payments to the original annuity payments	25/$100 or ¼
Lump sum received	$4,000
Less one-fourth of the remainder of the consideration (¼ of $15,000)	$3,750
Portion of the lump sum includible in gross income	$250

For taxable years beginning before January 1,1964, the limit on tax of section 72(e)(3), as in effect before such date, applies to the portion of the lump sum includible in gross income. For taxable years beginning after December 31, 1963, such portion may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). If, in this example, the annuity were a pension payable to A as a retired employee, but the facts were otherwise the same (assuming that, for instance, the $20,000 aggregate of premiums or other consideration paid were A's contributions as determined under section 72(f) and § 1.72-8) the result would be the same except that the tax attributable to the inclusion of the $250 in A's gross income, for taxable years beginning before January 1, 1964, would not be limited by section 72(e)(3), as in effect before such date. If such a lump sum is received in a taxable year beginning after December 31, 1963, the portion of such sum includible in gross income may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

Example (2). Taxpayer B pays $30,000 for a contract providing for monthly payments to be made to him for 15 years with respect to the principal and earnings of 10 units of an investment fund. B receives $12,000 during the first 5 years of participation and of this amount he has properly excluded a total of $10,000 from his gross income in his income returns for the taxable years, since $2,000 of $2,400 he received in each such year represented his investment divided by the term of the annuity ($30,000÷15). At the beginning of the 6th year, B agrees to take $11,000 in a lump sum and thereafter to accept the payments arising with respect to five units for the remaining 10 years of payments in full discharge of the original obligations of the contract. B shall include

$1,000 in his gross income for the 6th year as the result of the lump sum he receives and allocates $1,000 of his original investment in the contract to each of the remaining 10 years with respect to the payments which will continue, determined as follows:

Aggregate of premiums or other consideration paid	$30,000
Total amount received and excludable from gross income	$10,000
Remainder of the consideration	$20,000
Ratio of units discontinued to the total units originally provided	5/10 or 1/2
Lump sum received at the time of reduction in the number of units to be paid	$11,000
Less one-half of the remainder of the consideration (1/2 of $20,000)	$10,000
Portion of the lump sum received and includible in gross income	$1,000
Remainder of the consideration less the portion of such remainder attributable to the excludable portion of the lump sum ($20,000−$10,000)	$10,000
Remainder of the consideration properly allocable to each taxable year for the remaining 10 years ($10,000÷10)	$1,000

For the taxable years beginning before January 1, 1964, the limit on tax of section 72(e)(3), as in effect before such date, applies to the portion of the lump sum received and includible in gross income. For taxable years beginning after December 31, 1963, such portion may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(g) *Limit on tax attributable to the receipt of a lump sum.* (1) For taxable years beginning before January 1, 1964, if the entire amount of the proceeds received upon the redemption, maturity, surrender, or discharge of a contract to which section 72 applies is received in a lump sum and paragraph (c), (d), or (f) of this section is applicable in determining the portion of such amount which is includible in gross income, the tax attributable to such portion shall not exceed the tax which would have been attributable thereto had such portion been received ratably in the taxable year in which received and the 2 preceding taxable years. The amount of tax attributable to the includible portion of the lump sum received shall be the lesser of:

(i) The difference between the amount of tax for the taxable year of receipt computed by including such portion in gross income and the amount of tax for such taxable year computed by excluding such portion from gross income; or

(ii) The difference between the total amount of tax for the taxable year of receipt and the 2 preceding taxable years computed by including one-third of such portion in gross income for each of the 3 taxable years, and the total amount of the tax for the taxable year of receipt and the 2 preceding taxable years computed by entirely excluding such portion from the gross income of all 3 taxable years.

For the definition of "taxable year", see section 441(b). This subparagraph shall not apply, for taxable years beginning before January 1, 1964, to payments excepted from the application of section 72(e)(3), as in effect before such date, under the provisions of section 402 or 403. See paragraph (a) of § 1.72-2 and paragraph (d) of § 1.72-14.

(2) For taxable years beginning after December 31, 1963, any amount includible in gross income to which this section relates may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(h) *Amounts deemed to be paid or received by a transferee.* Amounts deemed to have been paid or received by a transferee for the purposes of § 1.72-10 shall also be deemed to have been so paid or received by such transferee for the purposes of this section. Thus, if a donee is deemed to have paid the premiums or other consideration actually paid by his transferor for the purposes of section 72(g) and paragraph (b) of § 1.72-10, such consideration shall be deemed premiums or other consideration paid by the donee for the purposes of this section.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6885, 31 FR 7798, June 2, 1966]

§ 1.72-12 Effect of taking an annuity in lieu of a lump sum upon the maturity of a contract.

If a contract to which section 72 applies provides for the payment of a lump sum in full discharge of the obligation thereunder and the obligee entitled thereto, prior to receiving any portion of such lump sum and within 60 days after the date on which such

lump sum first becomes payable, exercises an option or irrevocably agrees with the obligor to take, in lieu thereof, payments which will constitute "amounts received as an annuity", as that term is defined in paragraph (b) of § 1.72-2, no part of such lump sum shall be deemed to have been received by the obligee at the time he was first entitled thereto merely because he would have been entitled to such amount had he not exercised the option or made such an agreement with the obligor.

§ 1.72-13 Special rule for employee contributions recoverable in three years.

(a) *Amounts received as an annuity.* (1) Section 72(d) provides a special rule for the treatment of amounts received as an annuity by an employee (or by the beneficiary or beneficiaries of an employee) under a contract to which section 72 applies. This special rule is applicable only in the event that:

(i) At least part of the consideration paid for the contract is contributed by the employer, and

(ii) The aggregate amount receivable as an annuity under such contract by the employee (or by his beneficiary or beneficiaries if the employee died before any amount was received as an annuity under the contract) within the 3-year period beginning on the date (whether or not before January 1, 1954) on which an amount is first received as an annuity equals or exceeds the total consideration contributed (or deemed contributed under section 72(f) and § 1.72-8) by the employee as of such date as reduced by all amounts previously received and excludable from the gross income of the recipient under the applicable income tax law.

In such an event, section 72(d) provides that all amounts received as an annuity under the contract during a taxable year to which the Code applies shall be excluded from gross income until the total of the amounts excluded under that section plus all amounts excluded under prior income tax laws equals or exceeds the consideration contributed (or deemed contributed) by the employee. The excess, if any, and all amounts received by any recipient thereafter (whether or not received as an annuity), shall be fully included in gross income. See paragraph (b) of this section.

(2) If the aggregate amount receivable as an annuity under the contract within three years from the date on which an amount is first received as an annuity thereunder will not equal or exceed the consideration contributed (or deemed contributed) by the employee in accordance with the provisions of § 1.72-8, computed as of such date, the special rule of section 72(d) shall not apply to amounts received as an annuity under the contract and the general rules of section 72 shall apply thereto.

(3) The aggregate of the amounts receivable as an annuity within the prescribed 3-year period shall be the total of all annuity payments anticipatable by an employee (or a beneficiary or beneficiaries of an employee, if the employee died before any amount was received as an annuity) under the contract as a whole as defined in paragraph (a) of § 1.72-2. See paragraph (a)(3) of § 1.72-2 for rules for determining what constitutes "the contract" in the case of distributions from an employees' trust or plan.

(4) If subparagraphs (1) and (3) of this paragraph apply to amounts received as an annuity under a contract, the rule prescribed in subparagraph (1) of this paragraph shall apply to all amounts so received thereunder regardless of the fact that they may be payable (i) to more than one beneficiary, (ii) for the same or different intervals, (iii) in different sums, or (iv) for a different period certain, life, or lives.

(5) For purposes of section 72(d), contributions which are made with respect to a self-employed individual and which are allowed as a deduction under section 404(a) are not considered contributions by the employee, but such contributions are considered contributions by the employer. A contribution which is deemed paid in a prior taxable year under the provisions of section 404(a)(6) shall be considered made with respect to a self-employed individual if the individual on whose behalf the contribution is made was self-employed for the taxable year in which the contribution is deemed

paid, whether or not such individual is self-employed at the time the contribution is actually paid. Contributions with respect to a self-employed individual who is an owner-employee used to purchase life, accident, health, or other insurance protection for such owner-employee shall not be treated as consideration for the contract contributed by the employee in computing the employee contributions for purposes of section 72(d).

(b) *Amounts not received as an annuity.* If the rule of paragraph (a) of this section applies to a contract and, after the date on which an annuity payment is first received, amounts are received other than as an annuity under such contract in a taxable year to which the Code applies, they shall be included in the gross income of the recipient in accordance with the provisions of § 1.72-11. Thus, if such amounts are received as a dividend or a similar distribution after the date on which an amount is first received as an annuity under the contract, they shall be included in the gross income of the recipient (in accordance with section 72(e)(1)(A) and paragraph (b)(2) of § 1.72-11. All other amounts not received as an annuity shall be included in the gross income of the recipient in accordance with the provisions of section 72(e)(1)(B) and paragraph (c), (d), or (f), whichever is applicable, of § 1.72-11. See section 72(e)(2).

(c) *Amounts received after the exhaustion of employee contributions.* (1) Amounts received under a contract to which the rule of paragraph (a) of this section applies (whether or not such amounts are received as an annuity) shall be included in the gross income of the recipient if such amounts are received after the date on which the aggregate of all amounts excluded from gross income by the recipients under section 72(d) and prior income tax laws equalled or exceeded the consideration contributed (or deemed contributed) by the employee.

(2) If the rule of paragraph (a) of this section applies to amounts received by an employee (or his beneficiary or beneficiaries) under a joint and survivor annuity contract, payments made to a prior annuitant may entirely exhaust the amounts excludable from gross income. In such case, amounts paid to the surviving annuitant (or annuitants) shall be included in gross income by such recipients.

(d) *Application of section 72(d) to a contract, trust, or plan providing for payments in a manner described in paragraph (b)(3)(i) of § 1.72-2.* For the purpose of applying section 72(d) and this section, any amount received in the nature of a periodic payment under a contract, trust, or plan which provides for the payment of amounts in a manner described in paragraph (b)(3)(i) of § 1.72-2 shall be considered an amount received as an annuity notwithstanding the provisions of any other section of the regulations under section 72. The special exclusion rule of section 72(d) and paragraph (a) of this section shall apply to all amounts so received if the first amount received, when multiplied by the number of periodic payments to be made within the three years beginning on the date of its receipt, results in an amount in excess of the aggregate premiums or other consideration contributed (or deemed contributed) by the employee as of that date. If more than one series of periodic payments is to be paid under the same contract, trust, or plan, all payments anticipatable, whether because fixed in amount or determinable in the manner described in the preceding sentence, shall be aggravated for the purpose of determining the applicability of section 72 (d) to the contract, trust, or plan as a whole.

(e) *Inapplicability of section 72(d) and this section.* Section 72(d) and this section do not apply to:

(1) Amounts received as proceeds of a life insurance contract to which section 101(a) applies, nor to

(2) Amounts paid to a surviving annuitant under a joint and survivor annuity contract to which paragraph (b)(3) of § 1.72-5 applies, nor to

(3) Amounts paid to an annuitant under chapter 73 of title 10 of the United States Code with respect to which section 72(o) and § 1.122-1 apply.

See also paragraph (d) of § 1.72-14.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6497, 25 FR 10021, Oct. 20, 1960; T.D. 6676, 28 FR 10135, Sept. 17, 1963; T.D. 7043, 35 FR 8477, June 2, 1970]

§ 1.72-14 Exceptions from application of principles of section 72.

(a) *Payments of interest.* If any amount is received under an agreement to pay interest on a sum or sums held by the obligor, such amount shall not be excludable from the gross income of the recipient under the provisions of section 72 to the extent that it is an actual interest payment. See section 72(j). An amount shall be considered to be held under an agreement to pay interest thereon if the amount payable after the term of the annuity (whether for a term certain or for a life or lives) is substantially equal to or larger than the aggregate amount of premiums or other consideration paid therefor. For this purpose, however, the aggregate amount of premiums or other consideration paid shall include all contributions made by an employer and not merely those to which section 72(f) applies.

(b) *Alimony payments.* To the extent that payments made to a wife are includable in her gross income by reason of either or both section 71 and 682, they shall not be excluded from the wife's gross income under the principles of section 72 although made under a contract to which that section applies. However, section 72 shall apply in the case of amounts received under such a contract if a husband and wife are entitled to make and do make a single return jointly.

(c) *Certain "face-amount certificates."* The principles of section 72 do not apply to "face-amount certificates" described in section 72(l) which were issued before January 1, 1955.

(d) *Employer plans.* The provisions of §§ 1.72-1 to 1.72-13, inclusive, shall be disregarded to the extent that they are inconsistent with the treatment of amounts received provided in section 402 (relating to the taxability of a beneficiary of an employees' trust), section 403 (relating to the taxation of employee annuities), or the regulations under either of such sections.

§ 1.72-15 Applicability of section 72 to accident or health plans.

(a) *Applicability of section.* This section provides the rules for determining the taxation of amounts received from an employer-established plan which provides for distributions that are taxable under section 72 (or for distributions that are taxable under section 402 (a)(2) or (e), or section 403(a)(2), in the case of lump sum distributions) and which also provides for distributions that may be excludable from gross income under section 104 or 105 as accident or health benefits. For example, this section will apply to a pension plan described in section 401 and exempt under section 501 which provides for the payment of pensions at retirement and the payment of an earlier pension in the event of permanent disability. This section will also apply to a profit-sharing plan described in section 401 and exempt under section 501 which provides for periodic distribution of the amount standing to the account of a participant during any period that the participant is absent from work due to a personal injury or sickness and for the distribution of any balance standing to the account of the participant upon his separation from service. For purposes of this section, the term "contributions of the employee" includes contributions by the employer which were includible in the employee's gross income. For special rules for taxable years ending before January 27, 1975, relating to certain accident or health benefits which were treated as distributions to which section 72 applied, see paragraph (i) of this section.

(b) *General rule.* Section 72 does not apply to any amount received as an accident or health benefit, and the tax treatment of any such amount shall be determined under sections 104 and 105. See paragraphs (c) and (d) of this section, paragraph (d) of § 1.104-1, and §§ 1.105-1 through 1.105-5. Section 72 (or, in the case of certain total distributions, section 402(a)(2) or section 403(a)(2)) does apply to any amount which is received under a plan to which this section applies and which is not an accident or health benefit. See paragraph (e) of this section.

(c) *Accident or health benefits attributable to employee contributions.* (1) If a plan to which this section applies provides that any portion of the accident or health benefits is attributable to the contributions of the employee to such plan, then such portion of such benefits is excludable from gross income under section 104(a)(3) and paragraph (d) of § 1.104–1. Neither section 72 nor section 105 applies to any accident or health benefits (whether paid before or after retirement) attributable to contributions of the employee. Since such portion is excludable under section 104(a)(3), such portion is not subject to the dollar limitation of section 105(d) and if such portion is payable after the retirement of the employee, it is excludable without regard to the provisions of § 1.105–4 and section 72.

(2) In determining the taxation of any amounts received as accident or health benefits from a plan to which this secton applies, the first step is to determine the portion, if any, of the contributions of the employee which is used to provide the accident or health benefits and the portion of the accident or health benefits attributable to such portion of the employee's contributions. If such a plan expressly provides that the accident or health benefits are provided in whole or in part by employee contributions and the portion of employee contributions to be used for such purpose, the contributions so used will be treated as used to provide accident or health benefits. However, if the plan does not expressly provide that the accident or health benefits are to be provided with employee contributions and the portion of employee contributions to be used for such purpose, it will be presumed that none of the employee contributions is used to provide such benefits. Thus, in the case of a contributory pension plan, it will be presumed that the disability pension is provided by employer contributions, unless the plan expressly provides otherwise, or in the case of a contributory profit-sharing plan providing that a portion of the amount standing to the account of each participant will be used to purchase accident or health insurance, it will be presumed that such insurance is purchased with employer contributions, unless the plan expressly provides otherwise. Similarly, unless the plan expressly provides otherwise, it will be presumed that if a contributory profit-sharing plan provides for periodic distributions from the account of a participant during any absence from work because of a personal injury or sickness, all such distributions which do not exceed the contributions of the employer plus earnings thereon are provided by employer contributions.

(3) Any employee contributions that are treated under subparagraph (2) of this paragraph as used to provide accident or health benefits shall not be included for any purpose under section 72 as employee contributions or as aggregate premiums or other consideration paid. Thus, in the case of a pension plan, or in the case of a profit-sharing plan providing that a portion of the amount standing to the account of each participant will be used to purchase accident or health insurance, any employee whose contributions are so used must make the adjustment provided by this subparagraph irrespective of whether such employee receives any accident or health benefits under such plan. However, in the case of a profit-sharing plan providing for periodic distributions from the account of a participant during any absence from work because of a personal injury or sickness, an adjustment under this subparagraph is required only when an employee receives distributions in excess of the employer contributions and earnings thereon or receives distributions consisting in whole or in part of his own contributions.

(4) If any of the employee contributions are treated under subparagraph (2) of this paragraph as used to provide any of the accident or health benefits, the portion of the benefits attributable to employee contributions shall be determined in accordance with § 1.105–1. Any accident or health benefits that are excludable under section 104(a)(3) shall not be included in the expected return for purposes of section 72.

(d) *Accident or health benefits attributable to employer contributions.* Any amounts received as accident or health benefits and not attributable to contri-

butions of the employee are includable in gross income except to the extent that such amounts are excludable from gross income under section 105 (b), (c), or (d) and the regulations thereunder. Thus, such amounts may be excludable under section 105(d) as payments under a wage continuation plan. However, if such payments, when added to other such payments attributable to employer contributions, exceed the limitations of section 105(d), then the excess is includable in gross income under section 105(a). Such excess is not excludable under section 72. See, however, paragraph (i) of this section, for special rules for taxable years ending before January 27, 1975, relating to certain accident or health benefits which were treated as distributions to which section 72 applied.

(e) *Other benefits under the plan.* The taxability of amounts that are received under a plan to which this section applies and that are not accident or health benefits is determined under section 72 (or, in the case of certain total distributions, under section 402(a)(2) or section 403(a)(2)) without regard to any exclusion or inclusion of accident or health benefits under sections 104 and 105. For example, the investment in the contract or aggregate premiums paid is determined without regard to the exclusion of any amount under section 104 or 105, and the annuity starting date is determined without regard to the receipt of any accident or health benefits. However, if any employee contributions are used to provide any accident or health benefits, the investment in the contract or aggregate premiums paid must be adjusted as provided in paragraph (c)(3) of this section.

(f) *Examples.* The principles of this section may be illustrated by the following examples:

Example (1). A, an employee, is a participant in a contributory pension plan described in section 401(a) and exempt under section 501(a). Such plan provides for the payment of a pension to each participant when he retires at age 65 or when he retires earlier if the retirement is due to permanent and total disability. In 1964, A, who was age 52, became totally and permanently disabled because of an injury, was hospitalized, and commenced to receive a pension of $74 a week under this plan. The weekly amounts received by A do not exceed 75 percent of his "regular weekly rate of wages" under section 105(d). A had contributed $11,500 to the plan. The plan does not expressly provide that any portion of the disability pension is purchased with employee contributions. Accordingly, it is presumed that no portion of the disability pension is purchased with A's contributions. The disability pension which A receives qualifies as payments under a wage continuation plan for purposes of section 105(d) and § 1.105-4, and if such payments are the only accident or health benefits which are attributable to the contributions of his employer, such payments are entirely excludable under section 105(d) until A reaches age 65, his mandatory retirement age under the plan. The payments which A receives after he becomes age 65 are taxable under section 72. The payments which A receives do constitute an annuity as defined in paragraph (b) of § 1.72-2, but since the amounts which he will receive during the first three years after attaining age 65 exceed his contributions, he shall exclude under § 1.72-13 the entire amount of all payments that he receives as an annuity after attaining age 65 until such amounts equal his contributions to the plan, or $11,500. Thereafter, the payments that he receives under the plan are includible in gross income.

Example (2). B, an employee, is a participant in a contributory profit-sharing plan described in section 401(a) and exempt under section 501(a). Such plan provides that, in the event a participant is absent from work because of a personal injury or sickness, he will be paid $125 a week out of his account in such plan. Such weekly amount does not exceed 75 percent of B's "regular weekly rate of wages" under section 105(d). Any amount standing to the account of a participant at the time of his separation from service will be paid to him at such time. During 1964, B incurred a personal injury, was hospitalized, and as a result was absent from work for nine weeks. He received nine weekly payments of $125, or a total of $1,125, on account of such absence from work. At the time B was injured, he had contributed $5,000 to the plan. The plan did not expressly provide that a participant's contributions are to be used to provide for the distributions during disability. Accordingly, it is presumed that B's contributions were not used to provide the accident or health benefits under the plan. Since these weekly payments are paid because of B's absence from work due to the injury, and since such payments are considered as attributable to contributions of his employer, such payments are required under section 105(a) to be included in B's gross income except to the extent that they

are excludable under section 105(d). If B receives no other payments under a wage continuation plan attributable to contributions of his employer, during the first 30 days in the period of absence $75 of each weekly payment is excludable from gross income under section 105(d), but $50 of each weekly payment is includable in gross income under section 105(a). Amounts attributable to the period of absence in excess of 30 days are excludable from gross income under section 105(d) to the extent of $100 a week and includible in gross income under section 105(a) to the extent of $25 a week. The excludable portion of payments does not reduce B's investment in the contract or the amount of premiums considered to have been paid by B for purposes of any subsequent computations under section 72.

Example (3). The facts are the same as in example (2) except that B was absent from work for 130 weeks. At the time B was injured, his employer had contributed $10,000 to the plan on his account, and $6,000 of earnings of the plan had been allocated to his account. Thus, at the time he was injured, B's account included $21,000, and $14,000 of such amount consists of employer contributions of $10,000 plus earnings of $4,000 thereon. The first 112 weekly payments (totaling $14,000) which B receives are treated in the manner set forth in example (2). However, since the remaining payments exceed the employer contributions plus earnings thereon, such remaining payments are considered to be distributions of B's contributions plus earnings thereon. Since the total of such payments, or $2,250, is less than B's contributions to the plan, $5,000, the entire amount of such payments is excludable from B's gross income, but a corresponding adjustment with respect to the return of B's contributions shall be made to his consideration in determining the taxation of any lump sum paid to B upon separation from service.

(g) *Payments to or on behalf of a self-employed individual.* A self-employed individual is not considered an employee for purposes of section 105, relating to amounts received by employees under accident and health plans, nor for purposes of excluding under section 104(a)(3) amounts received by him under an accident and health plan as referred to in section 105(e). See section 105(g) and paragraph (a) of § 1.105-1. Therefore, the other paragraphs of this section are not applicable to amounts received by or on behalf of a self-employed individual. Except where accident or health benefits are provided through an insurance contract or an arrangement having the effect of insurance, all amounts received by or on behalf of a self-employed individual from a plan described in section 401(a) and exempt under section 501(a) or a plan described in section 403(a) shall be taxed as otherwise provided in section 72, 402, or 403. If the accident or health benefits are paid under an insurance contract or under an arrangement having the effect of insurance, section 104(a)(3) shall apply. Section 72 shall not apply to any amounts received under such circumstances. For the treatment of the amounts paid for such accident or health benefits, see section 404(e)(3) and paragraph (f) of § 1.404(e)-1.

(h) *Medical benefits for retired employees, etc.* Employer contributions to provide medical benefits described in section 401(h) under a qualified pension or annuity plan are not includible in the gross income of the employee on whose behalf such contributions were made. Similarly, if the trustee of a trust forming a part of a qualified pension plan applies employer contributions which have been contributed to provide medical benefits described in section 401(h) or earnings thereon, to purchase insurance contracts which provide such benefits, the amount so applied is not includible in the gross income of the employee on whose behalf such insurance was purchased. The payment of medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401-14 under a plan established by an employer shall be treated in the same manner as the payment of any other accident or health benefits under an employer-established plan. See paragraphs (b), (c), and (d) of this section.

(i) *Special rules.* (1) Special rule for taxable years ending before January 27, 1975. A taxpayer who has reached retirement age, as defined in § 1.79-2(b)(3) (hereinafter referred to as "initial retirement age"), before January 27, 1975, and who has received payments under a plan described in paragraph (a) of this section, which are wage continuation benefits to which section 105(d) and this section apply, or which are treated as such by reason of the employee having so agreed under § 1.105-6, shall be entitled to an

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exclusion, in taxable years ending before January 27, 1975, with respect to payments received after initial retirement age but before mandatory retirement age, as defined in § 1.105-4(a)(3)(i)(B), which is the greater of:

(i) The amount actually excluded on an original return under section 72 (b) or (d) with respect to payments received after initial retirement age, to the extent such amount does not exceed an amount properly excludable under section 72 (b) or (d) if this paragraph and paragraph (b) of this section did not apply; or

(ii) The amount that would have been properly excludable under section 105(d) during the same period.

(2) *Investment in the annuity contract.* A taxpayer described in paragraph (i)(1) of this section, shall redetermine his investment in, consideration for, or basis of his annuity contract (hereinafter referred to in this paragraph as the "investment in the contract") in accordance with the applicable rules of section 72 and the regulations thereunder, and the rules of this paragraph. In making such redetermination the taxpayer's investment in his contract shall be decreased, by the excess (if any) of the amount which the taxpayer is entitled to exclude under paragraph (i)(1) of this section over the amount which could have been excluded under section 105(d) (subject to the limitations contained in such provision). Such investment in the contract shall be decreased only by the excess of the amount excluded under section 72 in taxable years ending before January 27, 1975, over the amount which could have been excluded under section 105(d) during the same period. For example, the investment in the contract shall not be decreased in the case of an individual who was retired from work on account of injury or sickness or a full taxable year, if the amount excluded under section 72 was less than $5,200, since the entire amount could have been excluded under section 105(d). On the other hand, if the amount excluded under section 72 was equal to or greater than $5,200 for a full taxablae year, for example, $6,000 for the full taxable year, then $5,200 shall be treated as excluded under section 105(d) and the investment in the contract shall be reduced by $800 ($6,000 − $5,200).

(3) *Surviving annuitants and beneficiaries.* (i) The rights of a surviving annuitant or beneficiary, with respect to the application of the rules of section 72, shall be based on the employee's investment in his annuity contract, as adjusted in accordance with the provisions of this paragraph. Thus, where an employee dies after having recomputed his investment as provided in paragraph (i)(2) of this section, and his contract provided a survivorship element, the survivor would assume the employee's recomputed investment for purposes of determining excludability of amounts under section 72.

(ii) Where a beneficiary failed to increase the amount treated as an employee's contribution toward his annuity contract to reflect the employee death benefit under section 101(b) and § 1.72-8(b), because the employee had treated his intitial retirement age as his annuity starting date, such beneficiary may apply section 101(b) as if the appropriate addition to basis had been made in the year of the employee's death, but only if the employee had not reached his mandatory retirement age (as defined in section § 1.105-4(a)(3)(i)(B)). For purposes of this paragraph, the amount treated as the secton 101(b) death benefit would be valued as of the date of the employee's death.

(4) *Records.* (i) For purposes of section 72 (b) and (d), and this section, the taxpayer shall maintain such records as are necessary to substantiate the amount treated as his investment in his annuity contract.

(ii) The Commissioner may prescribe a form and instructions with respect to the taxpayer's past and current treatment of amounts received under section 72 or 105, and the taxpayer's computation, or recomputation, of his investment in his annuity contract. Such form may be required to be filed with the taxpayer's returns for years in which amounts are excluded under section 72 or 105.

(5) *Cross references.* (i) See section 72(b)(4) and § 1.72-4(b) with respect to annuity starting dates.

(ii) See §§ 1.72-8(b) and 1.101-2(a)(2) with respect to treating certain amounts received by an estate or beneficiary as employee death benefits.

(iii) See § 1.105-4(a)(3)(i)(B) for the definition of "mandatory retirement age."

(iv) See § 1.105-6 with respect to the application of section 105(d) to certain amounts received as retirement annuities before January 27, 1975, where the employee would otherwise have been eligible for benefits to which section 105(d) applies.

(6) *Examples.* The provisions of this paragraph may be illustrated by the following examples. In such examples assume that the plan does not expressly provide that any portion of the disability pension is purchased with employee contributions. Accordingly, it is presumed that no portion of the disability pension is purchased with employee contributions. Also, assume that in each case the taxpayer retired only after he had been absent from work for at least 30 days on account of personal injuries or sickness:

Example (1). A, a calendar year taxpayer, retired because of disability on January 1, 1968, his 58th birthday, receiving $80 per week ($4,160 per year) under a plan which qualifies as a wage continuation plan under section 105(d) and § 1.105-4. Under the plan, A's initial retirement age is age 60 (January 1, 1970), and his mandatory retirement age is 65 (January 1, 1975). A's consideration for the contract was $10,000. For payments received in 1968 and 1969 A excluded the entire amount under section 105(d). Payments received with respect to periods after A's initial retirement age (January 1, 1970) were excluded under section 72(d) until his entire $10,000 consideration for his contract had been excluded. Thus, A applied section 72(d) to exclude $4,160 each year for taxable years 1970 and 1971, and $1,680 ($10,000 − ($4,160 + $4,160)) for 1972. In late 1974 A realized that he was entitled to treat the full amount received under his annuity as excludable under secton 105(d) rather than section 72 for the taxable years 1970 through 1974. Consequently, A filed amended returns for 1972 and 1973 excluding an additional $2,480 ($4,160 − $1,680) and $4,160, respectively, claiming refunds based upon such additional exclusions. Moreover, A's annuity starting date is January 1, 1975 (A's mandatory retirement age), and he excludes under section 72(d) for 1975, 1976, and 1977, $4,160, $4,160 and $1,680 ($10,000 − ($4,160 + $4,160)), respectively.

Example (2). B, a calendar year taxpayer retired because of disability, July 1, 1970, on his 58th birthday, receiving $1,000 per month under a plan which qualifies as a wage continuation plan for purposes of section 105(d) and § 1.105-4. Under the plan, B's initial retirement age is age 60 (July 1, 1972), and his mandatory retirement age is 65 (July 1, 1977). B's consideration for the contract was $25,000. For payments received in 1970 and 1971 B excluded under section 105(d) $2,600 and $5,200, respectively, of the $6,000 (6 × $1,000) and $12,000 (12 × $1,000) received under the plan. For the period January 1, 1972, through June 30, 1972, B excluded an additional $2,600 under section 105(d). For the period July 1, 1972, through December 31, 1972, B excluded under section 72(d)(1) the entire $6,000 in payments received under the plan. Similarly, under section 72(d)(1), B excluded the entire $12,000 in payments received under the plan in 1973, and in 1974 B excluded the remaining $7,000 of his annuity basis. In 1975, B realized that he will be entitled to take full advantage of the exclusion under section 105(d) for periods through June 30, 1977, when he would reach age 65. B need not file amended returns for 1972, 1973, and 1974, even though the amounts he excluded under section 72(d) (exceeded the amount he was entitled to exclude under section 105(d)). He must, however, recompute the amount that will be treated as his investment in his annuity contract. Thus, on July 1, 1977, B's annuity starting date, his investment in his annuity contract would be $13,000, recomputed as follows:

B's original investment	$25,000
Less amounts excluded under section 72 to the extent they exceed amounts that would have been excludable during the same period under section 105(d):	
1972 ($6,000 − 2,600)	3,400
1973 ($12,000 − 5,200)	6,800
1974 ($7,000 − 5,200)	1,800
Total	12,000
B's recomputed investment in his annuity contract	$13,000

Example (3). Assume the same facts as in example (2) except that B's investment in his annuity contract is $37,000, and he excluded under section 72(b) 16.9 percent, or $2,028, of the $12,000 received per year. Thus, for the period July 1, 1972, through December 31, 1972, B excluded under section 72(b) $1,014 (16.9 percent of $6,000), and $2,028 in both 1973 and 1974. B files amended returns for 1972, 1973 and 1974 claiming the exclusion under section 105(d). Thus, B restored to income $1,014 for 1972, and $2,028 for both 1973 and 1974, claiming $2,600 ($5,200 − $2,600) exclusion under section 105(d) for 1972 and a $5,200 exclusion

in both 1973 and 1974. Thus, for 1972 B is entitled to an additional exclusion of $1,586 ($2,600 − $1,014), and, for both 1973 and 1974, an additional exclusion of $3,172 ($5,200 − $2,028). On July 1, 1977, B's investment in the contract is $37,000.

Example (4). C, a calendar year taxpayer, retired because of disability on January 1, 1965, his 58th birthday, receiving payments of $500 per month under a plan which qualifies as a wage continuation plan for purposes of section 105(d) and § 1.105–4. C had contributed $18,000 toward the cost of his annuity contract. Under the plan, C's initial retirement age is age 60 (January 1, 1967) and C's mandatory retirement age is age 70 (January 1, 1977). For taxable years 1965 and 1966 C excluded from gross income under section 105(d) $5,200 of the $6,000 (12 × $500) he received from his employer as wage continuation benefits. On January 1, 1967, C began excluding all of the benefits C received in accordance with the rules of section 72(d). Thus, for 1967, 1968 and 1969, C excluded 100 percent of the annuity payments. For his taxable years 1970 through 1973, C included in his gross income all annuity payments. In 1974, C realized that he will be entitled to use the exclusion under section 105(d) through December 31, 1976 (until he reaches age 70). In 1974, C filed a timely claim for refund for his taxable years 1971, 1972, and 1973 (refunds for taxable year 1970 and prior years were barred by the statute of limitations), and continues to claim the exclusion under section 105(d) for 1974, 1975, and 1976. For 1977, C treats January 1, 1977, as the annuity starting date, and treats $15,600 as the investment in the contract. The $15,600 represents the $18,000 original investment in the contract reduced by the excess, $2,400, of the amount excluded under section 72 for 1967, 1968 and 1969 ($18,000) over the amount excludable under section 105(d) ($5,200 × 3) for such years.

Example (5). (i) D, a calendar year taxpayer, retired because of disability on June 30, 1965, receiving $100 per month under a plan which qualifies as a wage continuation plan for purposes of section 105(d) and § 1.105–4. Under the plan, the initial retirement age of D, whose birthday is January 1, is age 60 (January 1, 1967), and D's mandatory retirement age is age 70 (January 1, 1977). D had contributed $6,000 toward the cost of the annuity contract under such plan. For 1965 and 1966, D excluded under section 105(d) the entire amount received under the plan ($1600 and $1,200 respectively). For 1967 through 1973, D excluded $330 per year under section 72(b), or 27.5 percent of the $1,200 payment received under the plan per year.

(ii) In 1974, D realized that he will be entitled to use the exclusion provided in section 105(d) up until January 1, 1977, when he reaches his mandatory retirement age, and that he improperly applied section 72 to payments received in the years 1967 through 1973. In 1974, D filed a timely claim for refund with respect to the section 105(d) wage continuation benefits, for 1971, 1972 and 1973 (refunds for taxable year 1970 and prior years were barred by the statute of limitations), and continues to claim the section 105(d) exclusion for 1974, 1975 and 1976. D is entitled to an additional exclusion of $870 ($1,200 − $330) for each of the years 1971, 1972 and 1973.

(iii) Upon reaching mandatory retirement age on January 1, 1977, D treats such date as the annuity starting date, and treats $6,000 as the investment in the contract. The investment in the contract is not reduced, because the amount excluded under section 72(b) for 1967 through 1970 ($330 per year) does not exceed the amount excludable under section 105(d) ($1,200 per year), and the $330 per year excluded for 1971, 1972, and 1973 were restored to the investment in the contract. Therefore, assuming that D would be entitled to exclude 41.3 percent of the payments under the plan if the annuity starting date is January 1, 1977, D would be entitled to exclude $495.60 (41.3 percent of $1,200) per annum.

Example (6). Assume the facts stated in example (5) except that D's investment in his annuity contract is $100,000 and he received payments equaling $10,000 per year. Assume also, that D had excluded under section 72(b) 54.9 percent of the payments received under the plan through 1974. Consequently, he excluded $5,490 (54.9 percent of $10,000) from his gross income for the years 1967 through 1974. D need not file amended returns for 1971, 1972, 1973, and 1974, even though the amount he excluded under section 72(b) exceeded the amounts he was entitled to exclude under section 105(d). He must, however, recompute the amount that will be treated as his investment in his annuity contract. Thus, on January 1, 1977, D's annuity starting date, his investment in his annuity contract would be $97,680. This figure represents the original investment ($100,000) reduced by the amount excluded under section 72(b) for the years 1967–1974 ($8 \times \$5,490 = \$43,920$) over the amount properly excludable during those years under section 105(d) ($\$5,200 \times 8 = \$41,600$).

Example (7). Assume the same facts as in example (6) except that D's mandatory retirement age is 63 (January 1, 1970). D would redetermine his exclusion ratio for purposes of section 72(b) as of January 1, 1970, since D's mandatory retirement age is D's annuity starting date. D would treat $99,130 as his investment in his annuity contract as of such date for purposes of section 72(b). Assuming refunds for 1970 and prior

taxable years were barred by the statute of limitations, the $99,130 represents the original investment of $100,000 reduced by the excess of the amount excluded under section 72(b) for 1967, 1968, and 1969 ($5,490×3=$16,470) over the amount otherwise excludable during those years under section 105(d) ($5,200×3=$15,600). Therefore, assuming that D would be entitled to exclude 61.2 of the payments received under the plan if the annuity starting date is January 1, 1970, D would be entitled to exclude $6,120 (61.2 percent of the $10,000 received under the plan) per annum for 1971 and subsequent years. However, D is not entitled to exclude the additional $630 ($6,120−$5,490) for 1970, because credit or refund for 1970 and prior years is barred by the statute of limitations.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10135, Sept. 17, 1963; T.D. 6722, 29 FR 5069, Apr. 14, 1964; T.D. 6770, 29 FR 15366, Nov. 17, 1964; T.D. 7352, 40 FR 16664, Apr. 14, 1975]

§ 1.72-16 Life insurance contracts purchased under qualified employee plans.

(a) *Applicability of section.* This section provides rules for the tax treatment of premiums paid under qualified pension, annuity, or profit-sharing plans for the purchase of life insurance contracts and rules for the tax treatment of the proceeds of such a life insurance contract and of annuity contracts purchased under such plans. For purposes of this section, the term "life insurance contract" means a retirement income, an endowment, or other contract providing life insurance protection. The rules of this section apply to plans covering only common-law employees as well as to plans covering self-employed individuals.

(b) *Treatment of cost of life insurance protection.* (1) The rules of this paragraph are applicable to any life insurance contract—

(i) Purchased as a part of a plan described in section 403(a), or

(ii) Purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) if the proceeds of such contract are payable directly or indirectly to a participant in such trust or to a beneficiary of such participant.

The proceeds of a contract described in subdivision (ii) of this subparagraph will be considered payable indirectly to a participant or beneficiary of such participant where they are payable to the trustee but under the terms of the plan the trustee is required to pay over all of such proceeds to the beneficiary.

(2) If under a plan or trust described in subparagraph (1) of this paragraph, amounts which were allowed as a deduction under section 404, or earnings of the trust, are applied toward the purchase of a life insurance contract described in subparagraph (1) of this paragraph, the cost of the life insurance protection under such contract shall be included in the gross income of the participant for the taxable year or years in which such contributions or earnings are so applied.

(3) If the amount payable upon death at any time during the year exceeds the cash value of the insurance policy at the end of the year, the entire amount of such excess is considered current life insurance protection. The cost of such insurance will be considered to be a reasonable net premium cost, as determined by the Commissioner, for such amount of insurance for the appropriate period.

(4) The amount includible in the gross income of the employee under this paragraph shall be considered as premiums or other consideration paid or contributed by the employee only with respect to any benefits attributable to the contract (within the meaning of paragraph (a)(3) of § 1.72-2) providing the life insurance protection. However, if under the rules of this paragraph an owner-employee is required to include any amounts in his gross income, such amounts shall not in any case be treated as part of his investment in the contract.

(5) The determination of the cost of life insurance protection may be illustrated by the following example:

Example. An annual premium policy purchased by a qualified trust for a common-law employee provides an annuity of $100 per month upon retirement at age 65, with a minimum death benefit of $10,000. The insurance payable if death occurred in the first year would be $10,000. The cash value at the end of the first year is 0. The net insurance is therefore $10,000 minus 0, or $10,000. Assuming that the Commissioner has determined that a reasonable net premium cost for the employee's age is $5.85 per

$1,000, the premium for $10,000 of life insurance is therefore $58.50, and this is the amount to be reported as income by the employee for his taxable year in which the premium is paid. The balance of the premium is the amount contributed for the annuity, which is not taxable to the employee under a plan meeting the requirements of section 401(a), except as provided under section 402(a). Assuming that the cash value at the end of the second year is $500, the net insurance would then be $9,500 for the second year. With a net 1-year term rate of $6.30 for the employee's age in the second year, the amount to be reported as income to the employee would be $59.85.

(6) This paragraph shall not apply if the trust has a right under any circumstances to retain any part of the proceeds of the life insurance contract. But see paragraph (c)(4) of this section relating to the taxability of the distribution of such proceeds to a beneficiary.

(c) *Treatment of proceeds of life insurance and annuity contracts.* (1) If under a qualified pension, annuity, or profit-sharing plan, there is purchased either—

(i) A life insurance contract described in paragraph (b)(1) of this section, and the employee either paid the cost of the insurance or was taxable on the cost of the insurance under paragraph (b) of this section, or

(ii) An annuity contract,

the amounts payable under any such contract by reason of the death of the employee are taxable under the rules of subparagraph (2) of this paragraph, except in the case of a joint and survivor annuity.

(2)(i) In the case of an annuity contract, the death benefit is the accumulation of the premiums (plus earnings thereon) which is intended to fund pension or other deferred benefits under a pension, annuity, or profit-sharing plan. Such death benefits are not in the nature of life insurance and are not excludable from gross income under section 101(a).

(ii) In the case of a life insurance contract under which there is a reserve accumulation which is intended to fund pension or other deferred benefits under a pension, annuity, or profit-sharing plan, such reserve accumulation constitutes the source of the cash value of the contract and approximates the amount of such cash value. The portion of the proceeds paid upon the death of the insured employee which is equal to the cash value immediately before death is not excludable from gross income under section 101(a). The remaining portion, if any, of the proceeds paid to the beneficiary by reason of the death of the insured employee—that is, the amount in excess of the cash value—constitutes current insurance protection and is excludable under section 101(a).

(iii) The death benefit under an annuity contract, or the portion of the death proceeds under a life insurance contract which is equal to the cash value of the contract immediately before death, constitutes a distribution under the plan consisting in whole or in part of deferred compensation and is taxable to the beneficiary in accordance with section 72(m)(3) and the provisions of this paragraph, except to the extent that the limited exclusion from income provided in section 101(b) is applicable.

(iv) In the case of a life insurance contract under which the benefits are paid at a date or dates later than the death of the employee, section 101(d) is applicable only to the portion of the benefits which is attributable to the amount excludable under section 101(a). The portion of such benefits which is attributable to the cash value of the contract immediately before death is taxable under section 72, and in such case, any amount excludable under section 101(b) is treated as additional consideration paid by the employee in accordance with section 101(b)(2)(D).

(3) The application of the rules under subparagraph (2) of this paragraph with respect to the taxability of proceeds of a life insurance contract paid by reason of the death of an insured common-law employee who has paid no contributions under the plan is illustrated by the following examples:

Example (1).

Total face amount of the contract payable in a lump sum at time of death	$25,000
Cash value of the contract immediately before death	11,000

Excess over cash value, excludable under section 101(a)	14,000
Cash value subject to limited exclusion under section 101(b)	11,000
Excludable under section 101(b) (assuming that there is no other death benefit paid by or on behalf of any employer with respect to the employee)	5,000
Balance taxable in accordance with section 402(a)(2) or 403(a)(2) (assuming a total distribution in one taxable year of the distributee)	6,000
Portion of premiums taxed to employee under the provisions of paragraph (b) of this section and considered as contributions of the employee	940
Balance taxable as long-term capital gain	5,060

Example (2). The facts are the same as in example (1), except that the contract provides that the beneficiary may elect within 60 days after the death of the employee either to take the $25,000 or to receive 10 annual installments of $3,000 each, and the beneficiary elects to receive the 10 installments. In addition, the employee's rights to the cash value immediately before his death were forfeitable at least to the extent of $5,000. Section 101(d) is applicable to the amount excludable under section 101(a), that is, $14,000. The portion of each annual installment of $3,000 which is attributable to this $14,000 is determined by allocating each installment in accordance with the ratio which this $14,000 bears to the total amount which was payable at death ($25,000). Accordingly, the portion of each annual installment which is subject to section 101(d) is $1,680 ($^{14}/_{25}$ of $3,000), of which $1,400 ($^{1}/_{10}$ of $14,000) is excludable under section 101(a), and the remaining $280 is includible in the gross income of the beneficiary. However, if the beneficiary is a surviving spouse as defined in section 101(d)(3), the exclusion provided by section 101(d)(1)(B) is applicable to such $280. The remaining portion of each annual $3,000 installment, $1,320, is attributable to the cash value of the contract and is treated under section 72, as follows:

Amount actually contributed by the employee	0
Amount considered contributed by employee by reason of section 101(b)	$5,000
Portion of premiums taxed to employee under the provisions of paragraph (b) of this section and considered as contributions of the employee	$940
Investment in the contract	$5,940
Expected return, 10 × $1,320	$13,200
Exclusion ratio, $5,940 ÷ $13,200	0.45
Annual exclusion, 0.45 × $1,320	$594

Accordingly, $594 of the $1,320 portion of each annual installment is excludable each year under section 72, and the remaining $726 is includible. Thus, if the beneficiary is not a surviving spouse, a total of $1,006 ($280 plus $726) of each annual $3,000 installment is includible in income each year. If the beneficiary is a surviving spouse, and can exclude all of the $280 under section 101(d)(1)(B), the amount includible in gross income each year is $726 of each annual $3,000 installment.

(4) If an employee neither paid the total cost of the life insurance protection provided under a life insurance contract, nor was taxable under paragraph (b) of this section with respect thereto, no part of the proceeds of such a contract which are paid to the beneficiaries of the employee as a death benefit is excludable under section 101(a). The entire distribution is taxable to the beneficiaries under section 402(a) or 403(a) except to the extent that a limited exclusion may be allowable under section 101(b).

[T.D. 6676, 28 FR 10135, Sept. 17, 1963]

§ 1.72–17 Special rules applicable to owner-employees.

(a) *In general.* Under section 401(c) and section 403(a), certain self-employed individuals may participate in qualified pension, annuity, and profit-sharing plans, and the amounts received by such individuals from such plans are taxable under section 72. Section 72(m) and this section contain special rules for the taxation of amounts received from qualified pension, profit-sharing, or annuity plans covering an owner-employee. For purposes of section 72 and the regulations thereunder, the term "employee" shall include the self-employed individual who is treated as an employee by section 401(c)(1) (see paragraph (b) of § 1.401–10), and the term "owner-employee" has the meaning assigned to it in section 401(c)(3) (see paragraph (d) of § 1.401–10). See also paragraph (a)(2) of § 1.401–10 for the rule for determining when a plan covers an owner-employee. For purposes of this section, a self-employed individual may not treat as consideration for the contract contributed by the employee any contributions under the plan for which deductions were allowed under section 404 and which, consequently, are considered employer contributions.

(b) *Certain amounts received before annuity starting date.* (1) The rules of this paragraph are applicable to amounts received from a qualified

pension, profit-sharing, or annuity plan by an employee (or his beneficiary) who is or was an owner-employee with respect to such plan when such amounts—

(i) Are received before the annuity starting date; and

(ii) Are not received as an annuity.

For the definition of annuity starting date, see paragraph (b) of § 1.72-4 and subparagraph (4) of this paragraph. As to what constitutes amounts not received as an annuity, see paragraphs (c) and (d) of § 1.72-11.

(2) Amounts to which this paragraph applies shall be included in the recipient's gross income for the taxable year in which received. However, the sum of the amounts so included under this subparagraph in all taxable years shall not exceed the aggregate deductions allowed under section 404 for premiums or other consideration paid under the plan on behalf of the employee while he was an owner-employee, including any such deductions taken in the taxable year of receipt.

(3) Any amounts to which this paragraph applies and which are not includible in gross income under the rules of subparagraph (2) of this paragraph shall be subject to the provisions of section 72(e) and § 1.72-11. However, for taxable years beginning before January 1, 1964, section 72(e)(3), as in effect before such date, shall not apply to such amounts. For taxable years beginning after December 31, 1963, such amounts (other than amounts subject to a penalty under section 72(m)(5) and paragraph (e) of this section) may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(4) Under section 401(d)(4), a qualified pension, profit-sharing, or annuity plan may not provide for distributions to an owner-employee before he reaches age 59½ years, except in the case of his earlier disability. Therefore, in the case of a distribution from a qualified plan to an individual for whom contributions have been made to the plan as an owner-employee, the annuity starting date cannot be prior to the time such individual attains the age 59½ years unless he is entitled to benefits before reaching such age because of his disability. For taxable years beginning after December 31, 1966, see section 72(m)(7) and paragraph (f) of this section for the meaning of disabled. For taxable years beginning before January 1, 1967, see section 213(g)(3) for the meaning of disabled.

(5) The rules of this paragraph are not applicable to amounts credited to an individual in his capacity as a policy-holder of an annuity, endowment, or life insurance contract which are in the nature of a dividend or refund of premium, and which are applied in accordance with paragraph (a)(4) of § 1.404(a)-8 towards the purchase of benefits under the policy.

(6) The rules of this paragraph may be illustrated by the following example:

Example. B, a self-employed individual, received $8,000 as a distribution under a qualified pension plan before the annuity starting date. At the time of such distribution, $10,000 had been contributed (the whole amount being allowed as a deduction) under the plan on behalf of such individual while he was a common-law employee and $5,000 had been contributed under the plan on his behalf while he was an owner-employee, of which $2,500 was allowed as a deduction. In addition, B had contributed $1,000 on his own behalf as an employee under the plan. Of the $8,000, $2,500 (the amount allowed as a deduction with respect to contributions on behalf of the individual while he was an owner-employee) is includable in gross income under subparagraph (2) of this paragraph. With respect to the remaining $5,500, B has a basis of $3,500, consisting of the $2,500 contributed on his behalf while he was an owner-employee which was not allowed as a deduction and the $1,000 which B contributed as an employee. The difference between the $5,500 and B's basis of $3,500, or $2,000, is includable in gross income under section 72(e).

(c) *Amounts paid for life, accident, health, or other insurance.* Amounts used to purchase life, accident, health, or other insurance protection for an owner-employee shall not be taken into account in computing the following:

(1) The aggregate amount of premiums or other consideration paid for the contract for purposes of determining the investment in the contract under section 72(c)(1)(A) and § 1.72-6;

(2) The consideration for the contract contributed by the employee for purposes of section 72(d)(1) and § 1.72-13, which provide the method of taxing employees' annuities where the employee's contributions will be recoverable within 3 years; and

(3) The aggregate premiums or other consideration paid for purposes of section 72(e)(1)(B) and § 1.72-11, which provide the rules for taxing amounts not received as annuities prior to the annuity starting date.

The cost of such insurance protection will be considered to be a reasonable net premium cost, as determined by the Commissioner, for the appropriate period.

(d) *Amounts constructively received.* (1) If during any taxable year an owner-employee assigns or pledges (or agrees to assign or pledge) any portion of his interest in a trust described in section 401(a) which is exempt from tax under section 501(a), or any portion of the value of a contract purchased as part of a plan described in section 403(a), such portion shall be treated as having been received by such owner-employee as a distribution from the trust or as an amount received under the contract during such taxable year.

(2) If during any taxable year an owner-employee receives, either directly or indirectly, any amount from any insurance company as a loan under a contract purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) or purchased as part of a plan described in section 403(a), and issued by such insurance company, such amount shall be treated as an amount received under the contract during such taxable year. An owner-employee will be considered to have received an amount under a contract if a premium, which is otherwise in default, is paid by the insurance company in the form of a loan against the cash surrender value of the contract. Further, an owner-employee will be considered to have received an amount to which this subparagraph applies if an amount is received from the issuer of a face-amount certificate as a loan under such a certificate purchased as part of a qualified trust or plan.

(e) *Penalties applicable to certain amounts received by owner-employees.* (1)(i) The rules of this paragraph are applicable to amounts, to the extent includable in gross income, received from a trust described in section 401(a) or under a plan described in section 403(a) by or on behalf of an individual who is or has been an owner-employee with respect to such plan or trust—

(*a*) Which are received before the owner-employee reaches the age 59½ years and which are attributable to contributions paid on behalf of such owner-employee (whether or not paid by him) while he was an owner-employee (see subdivision (ii) of this subparagraph),

(*b*) Which are in excess of the benefits provided for such owner-employee under the plan formula (see subdivision (iii) of this subparagraph), or

(*c*) Which are received by reason of a distribution of the owner-employee's entire interest under the provisions of section 401(e)(2)(E), relating to excess contributions on behalf of an owner-employee which are willfully made.

(ii) The amounts referred to in subdivision (i) (*a*) of this subparagraph do not include—

(*a*) Amounts received by reason of the owner-employee becoming disabled, or

(*b*) Amounts received by the owner-employee in his capacity as a policyholder of an annuity, endowment, or life insurance contract which are in the nature of a dividend or similar distribution.

Amounts attributable to contributions paid on behalf of an owner-employee and which are paid to a person other than the owner-employee before the owner-employee dies or reaches the age 59½ shall be considered received by the owner-employee for purposes of this paragraph. For taxable years beginning after December 31, 1966, see section 72(m)(7) and paragraph (f) of this section for the meaning of disabled. For taxable years beginning before January 1, 1967, see section 213(g)(3) for the meaning of disabled. For taxable years beginning after December 31, 1968, if an amount is not included in the amounts referred to in

subdivision (i) (*a*) of this subparagraph solely by reason of the owner-employee becoming disabled and if a penalty would otherwise be applicable with respect to all or a portion of such amount, then for the taxable year in which such amount is received, there must be submitted with the owner-employee's income tax return a doctor's statement as to the impairment, and a statement by the owner-employee with respect to the effect of such impairment upon his substantial gainful activity and the date such impairment occurred. For taxable years which are subsequent to the first taxable year beginning after December 31, 1968, with respect to which the statements referred to in the preceding sentence are submitted, the owner-employee may, in lieu of such statements, submit a statement declaring the continued existence (without substantial diminution) of the impairment and its continued effect upon his substantial gainful activity.

(iii) This paragraph applies to amounts described in subdivision (i)(*b*) of this subparagraph (relating to excess benefits) even though a portion of such amounts may be attributable to contributions made on behalf of an individual while he was not an owner-employee and even though the amounts are received by his successor. However, these amounts do not include the portion of a distribution to which section 402(a)(2) or 403(a)(2) (relating to certain total distributions in one taxable year) applies.

(iv) (*a*) For purposes of subdivision (i)(*a*) of this subparagraph, the portion of any distribution or payment attributable to contributions on behalf of an employee-participant while he was an owner-employee includes the contributions made on his behalf while he was an owner-employee and the increments in value attributable to such contributions.

(*b*) The increments in value of an individual's account may be allocated to contributions on his behalf while he was an owner-employee either by maintaining a separate account, or an accounting, which reflects the actual increment attributable to such contributions, or by the method described in (*c*) of this subdivision.

(*c*) Where an individual is covered under the same plan both as an owner-employee and as a nonowner-employee, the portion of the increment in value of his interest attributable to contributions made on his behalf while he was an owner-employee may be determined by multiplying the total increment in value in his account by a fraction. The numerator of the fraction is the total contributions made on behalf of the individual as an owner-employee, weighted for the number of years that each contribution was in the plan. The denominator is the total contributions made on behalf of the individual, whether or not an owner-employee, weighted for the number of years each contribution was in the plan. The contributions are weighted for the number of years in the plan by multiplying each contribution by the number of years it was in the plan. For purposes of this computation, any forfeiture allocated to the account of the individual is treated as a contribution to the account made at the time so allocated.

(*d*) The method described in (*c*) of this subdivision may be illustrated by the following example:

Example. B was a member of the XYZ Partnership and a participant in the partnership's profit-sharing plan which was created in 1963. Until the end of 1967, B's interest in the partnership was less than 10 percent. On January 1, 1968, B obtained an interest in excess of 10 percent in the partnership and continued to participate in the profit-sharing plan until 1972. During 1972, prior to the time he attained the age of 59½ years and during a time when he was not disabled, B withdrew his entire interest in the profit-sharing plan. At that time his interest was $15,000, $9,600 contributions and $5,400 increment attributable to the contributions. The portion of the increment attributable to contributions while B was an owner-employee is $667.80, determined as follows:

	A	B	C
	Contribution	Number of years contribution was in trust—	Contribution weighted for years in trust (A × B)
1972	$1,000	0	0
1971	800	1	800

	A	B	C
	Contribution	Number of years contribution was in trust—	Contribution weighted for years in trust (A×B)
1970	1,200	2	2,400
1969	600	3	1,800
1968	200	4	800
1967	400	5	2,000
1966	2,000	6	12,000
1965	1,000	7	7,000
1964	1,500	8	12,000
1963	900	9	8,100
Total	$9,600		46,900

Total weighted contributions as owner-employee (1968-1972)—5,800.
Total weighted contributions—46,900.

$$\$5,400 \times (5,800 \div 46,900) = \$667.80$$

(2)(i) If the aggregate of the amounts to which this paragraph applies received by any person in his taxable year equals or exceeds $2,500 the tax with respect to such amount shall be the greater of—

(*a*) The increase in tax attributable to the inclusion of the amounts so received in his gross income for the taxable year in which received, or

(*b*) 110 percent of the aggregate increase in taxes, for such taxable year and the four immediately preceding taxable years, which would have resulted if such amounts had been included in such person's gross income ratably over such taxable years. However, if deductions were allowed under section 404 for contributions to the plan on behalf of the individual as an owner-employee for less than four prior taxable years (whether or not consecutive), the number of immediately preceding taxable years taken into account shall be the number of prior taxable years in which such deductions were allowed.

(ii) If the aggregate of the amounts to which this paragraph applies received by any person in his taxable year is less than $2,500, the tax with respect to such amounts shall be 110 percent of the increase in tax which results from including such amounts in the person's gross income for the taxable year in which received.

(3)(i) For purposes of making the ratable inclusion computations of subparagraph (2)(i) of this paragraph, the taxable income of the recipient for each taxable year involved (notwithstanding section 63, relating to definition of taxable income) shall be treated as being not less than the amount required to be treated as includible in the taxable year pursuant to the ratable inclusion.

(ii) For purposes of subparagraph (2)(i)(*a*) and (ii) of this paragraph, the recipient's taxable income (notwithstanding section 63, relating to definition of taxable income) shall be treated as being not less than the aggregate of the amounts to which this paragraph applies reduced by the deductions allowed the recipient for such taxable year under section 151 (relating to deductions for personal exemptions).

(iii) In any case in which the application of subdivision (i) or (ii) of this subparagraph results in an increase in taxable income for any taxable year, the resulting increase in taxes imposed by section 1 or 3 for such taxable year shall be reduced by the credits against tax provided by section 31 (tax withheld on wages) and section 39 (certain uses of gasoline and lubricating oil), but shall not be reduced by any other credits against tax.

(4) The application of the rules of subparagraph (2)(i) and (3) of this paragraph may be illustrated by the following example:

Example. B, a sole proprietor and a calendar-year basis taxpayer, established a qualified pension trust to which he made annual contributions for 10 years of 10 percent of his earned income. B withdrew his entire interest in the trust during 1973 when he was 55 years old and not disabled and for which, without regard to the distribution, he had a net operating loss and for which he is allowed under section 151 a deduction for one personal exemption. The portion of the distribution includible in B's gross income is $25,750. In addition, B had a net operating loss for 1972. The other 3 taxable years involved in the computation under subparagraph (2)(i) of this paragraph were years of substantial income. For purposes of determining B's increase in tax attributable to the receipt of the $25,750 (before the application of the provisions of subparagraph (2)(i)(*b*) of this paragraph), B's taxable income for the year he received the $25,750 is treated, under subparagraph (3)(ii) of this paragraph, as being $25,000 ($25,750 minus

$750, the amount of the deduction allowed for each personal exemption under section 151 for 1973). For purposes of determining whether 110 percent of the aggregate increase in taxes which would have resulted if 20 percent of the amount of the withdrawal had been included in B's gross income for the year of receipt and for each of the 4 preceding taxable years is greater (and thus is the amount of his increase in tax attributable to the receipt of the $25,750), B's taxable income for the taxable year of receipt, and for the immediately preceding taxable year, is treated, under subparagraph (3)(i) of this paragraph, as being $5,150 ($25,750 divided by 5).

(f) *Meaning of disabled.* (1) For taxable years beginning after December 31, 1966, section 72(m)(7) provides that an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. In determing whether an individual's impairment makes him unable to engage in any substantial gainful activity, primary consideration shall be given to the nature and severity of his impairment. Consideration shall also be given to other factors such as the individual's education, training, and work experience. The substantial gainful activity to which section 72(m)(7) refers is the activity, or a comparable activity, in which the individual customarily engaged prior to the arising of the disability (or prior to retirement if the individual was retired at the time the disability arose).

(2) Whether or not the impairment in a particular case constitutes a disability is to be determined with reference to all the facts in the case. The following are examples of impairments which would ordinarily be considered as preventing substantial gainful activity:

(i) Loss of use of two limbs;

(ii) Certain progressive diseases which have resulted in the physical loss or atrophy of a limb, such as diabetes, multiple sclerosis, or Buerger's disease;

(iii) Diseases of the heart, lungs, or blood vessels which have resulted in major loss of heart or lung reserve as evidenced by X-ray, electrocardiogram, or other objective findings, so that despite medical treatment breathlessness, pain, or fatigue is produced on slight exertion, such as walking several blocks, using public transportation, or doing small chores;

(iv) Cancer which is inoperable and progressive;

(v) Damage to the brain or brain abnormality which has resulted in severe loss of judgment, intellect, orientation, or memory;

(vi) Mental diseases (e.g. psychosis or severe psychoneurosis) requiring continued institutionalization or constant supervision of the individual;

(vii) Loss or diminution of vision to the extent that the affected individual has a central visual acuity of no better than 20/200 in the better eye after best correction, or has a limitation in the fields of vision such that the widest diameter of the visual fields subtends an angle no greater than 20 degrees;

(viii) Permanent and total loss of speech;

(ix) Total deafness uncorrectible by a hearing aid.

The existence of one or more of the impairments described in this subparagraph (or of an impairment of greater severity) will not, however, in and of itself always permit a finding that an individual is disabled as defined in section 72(m)(7). Any impairment, whether of lesser or greater severity, must be evaluated in terms of whether it does in fact prevent the individual from engaging in his customary or any comparable substantial gainful activity.

(3) In order to meet the requirements of section 72(m)(7), an impairment must be expected either to continue for a long and indefinite period or to result in death. Ordinarily, a terminal illness because of disease or injury would result in disability. Indefinite is used in the sense that it cannot reasonably be anticipated that the impairment will, in the foreseeable future, be so diminished as no longer to prevent substantial gainful activity. For example, an individual who suffers a bone fracture which prevents him from working for an extended period of time will not be considered disabled, if his recovery can be expect-

ed in the foreseeable future; if the fracture persistently fails to knit, the individual would ordinarily be considered disabled.

(4) An impairment which is remediable does not constitute a disability within the meaning of section 72(m)(7). An individual will not be deemed disabled if, with reasonable effort and safety to himself, the impairment can be diminished to the extent that the individual will not be prevented by the impairment from engaging in his customary or any comparable substantial gainful activity.

(g) *Years to which this section applies.* This section applies to taxable years ending before September 3, 1974. For taxable years ending after September 2, 1974, see § 1.72-17A.

[T.D. 6676, 28 FR 10136, Sept. 17, 1963, as amended by T.D. 6885, 31 FR 7800, June 2, 1966; T.D. 6985, 33 FR 19811, Dec. 27, 1968; T.D. 7114, 36 FR 9018, May 18, 1971; T.D. 7636, 44 FR 47049, Aug. 10, 1979]

§ 1.72-17A Special rules applicable to employee annuities and distributions under deferred compensation plans to self-employed individuals and owner-employees.

(a) *In general.* Section 72(m) and this section contain special rules for the taxation of amounts received from qualified pension, profit-sharing, or annuity plans covering an owner-employee. This section applies to such amounts for taxable years of the recipient ending after September 2, 1974, unless another date is specified. For purposes of this section, the term "employee" shall include the self-employed individual who is treated as an employee by section 401(c)(1), and the term "owner-employee" has the meaning assigned to it in section 401(c)(3). Paragraph (b) of this section provides rules dealing with the computation of consideration paid by self-employed individuals and paragraph (c) of this section provides rules dealing with such computation when insurance is purchased for owner-employees. Paragraph (d) of this section provides rules for constructive receipt and, for purposes of these rules, treats as an owner-employee an individual for whose benefit an individual retirement account or annuity described in section 408 (a) or (b) is maintained after December 31, 1974. Paragraph (e) of this section provides rules for penalties provided by section 72(m)(5) with respect to certain distributions received by owner-employees or their successors. Paragraph (f) of this section provides rules for determining whether a person is disabled within the meaning of section 72(m)(7). See § 1.72-16, relating to life insurance contracts purchased under qualified employee plans, for rules under section 72(m)(3).

(b) *Computation of consideration paid by self-employed individuals.* Under section 72(m)(2), consideration paid or contributed for the contract by any self-employed individual shall for purposes of section 72 be deemed not to include any contributions paid or contributed under a plan described in paragraph (a), or any other plan of deferred compensation described in section 404(a) (whether or not qualified), if the contributions are—

(1) Paid under such plan with respect to a time during which the employee was an employee only by reason of sections 401(c)(1) and 404(a)(8), and

(2) Deductible under section 404 by the employer, including an employer within the meaning of sections 401(c)(4) and 404(a)(8), of such self-employed individual at the time of such payment, or subsequent to such time of payment.

For purposes of this paragraph the term "consideration paid or contributed for the contract" has the same meaning as under subparagraphs (1), (2), and (3) of paragraph (c) of this section.

(c) *Amounts paid for life, accident, health, or other insurance.* Under section 72(m)(2), amounts used to purchase life, accident, health, or other insurance protection for an owner-employee shall not be taken into account in computing the following:

(1) The aggregate amount of premiums or other consideration paid for the contract for purposes of determining the investment in the contract under section 72(c)(1)(A) and § 1.72-6;

(2) The consideration for the contract contributed by the employee for

purposes of section 72(d)(1) and § 1.72-13, which provide the method of taxing employee's annuities where the employee's contributions will be recoverable within 3 years; and

(3) The aggregate premiums or other consideration paid for purposes of section 72(e)(1)(B) and § 1.72-11, which provide the rules for taxing amounts not received as annuities prior to the annuity starting date.

The cost of such insurance protection will be considered to be a reasonable net premium cost, as determined by the Commissioner, for the appropriate period.

(d) *Amounts constructively received.* (1) Under section 72(m)(4)(A), if during any taxable year an owner-employee assigns or pledges (or agrees to assign or pledge) any portion of his interest in a trust described in section 401(a) which is exempt from tax under section 501(a), or any portion of the value of a contract purchased as part of a plan described in section 403(a), such portion shall be treated as having been received by such owner-employee as a distribution from the trust or as an amount received under the contract during such taxable year.

(2)(i) Under paragraphs (4)(A) and (6) of section 72(m), if after December 31, 1974, during any taxable year an individual for whose benefit an individual retirement account or annuity described in section 408 (a) or (b) is maintained assigns or pledges (or agrees to assign or pledge) any portion of his interest in such account or annuity, such portion shall be treated as having been received by such individual as a distribution from such account or trust during such taxable year. See subsections (d) and (f) of section 408 and the regulations thereunder for the tax treatment of an amount treated as a distribution under this subparagraph.

(ii) Notwithstanding subdivision (i) of this subparagraph, if an individual retirement account or annuity, or portion thereof, is subject to the additional tax imposed by section 408(f), that amount shall be deemed not to be a distribution under section 72(m)(4)(A) and subdivision (i) of this subparagraph.

(3) Under section 72(m)(4)(B), if during any taxable year an owner-employee receives, either directly or indirectly, any amount from any insurance company as a loan under a contract purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) or purchased as part of a plan described in section 403(a), and issued by such insurance company, such amount shall be treated as an amount received under the contract during such taxable year. An owner-employee will be considered to have received an amount under a contract if a premium, which is otherwise in default, is paid by the insurance company in the form of a loan against the cash surrender value of the contract. Further, an owner-employee will be considered to have received an amount to which this subparagraph applies if an amount is received from the issuer of a face-amount certificate as a loan under such a certificate purchased as part of a qualified trust or plan.

(e) *Penalties applicable to certain amounts received with respect to owner-employees under section 72(m)(5).* (1) (i) For taxable years of the recipient beginning after December 31, 1975, if any person receives an amount to which subparagraph (2) of this paragraph applies, his tax under chapter 1 for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of the amount so received which is includible in his gross income for such taxable year.

(ii) For taxable years of the recipient beginning before January 1, 1976, see subparagraph (3) of this paragraph.

(2) (i) This subparagraph is applicable to amounts, to the extent includible in gross income, received from a qualified trust described in section 401(a) or under a plan described in section 403(a) by or on behalf of an individual who is or has been an owner-employee with respect to such trust or plan—

(A) Which are received before the owner-employee reaches the age of 59½ years, and which are attributable to contributions paid on behalf of such owner-employee by his employer

(that is employer contributions within the meaning of section 401(c)(5)(A) and the increments in value attributable to such employer contributions) and the increments in value attributable to contributions made by him as an owner-employee while he was an owner-employee (that is, the increments attributable to owner-employee contributions within the meaning of section 401(c)(5)(B), but not such contributions; see subdivision (ii) of this subparagraph).

(B) Which are in excess of the benefits provided for such owner-employee under the plan formula (see subdivision (iii) of this subparagraph), or

(C) Which are subject to the transitional rules with respect to willful excess contributions made on behalf of an owner-employee in his employer's taxable years which begin before January 1, 1976 (see subdivision (v) of this subparagraph).

(ii) The amounts referred to in subdivision (i)(A) of this subparagraph do not include—

(A) Amounts received by reason of the owner-employee becoming disabled (see paragraph (f) of this section).

(B) Amounts received by the owner-employee in his capacity as a policyholder of an annuity, endowment, or life insurance contract which are in the nature of a dividend or similar distribution, or

(C) Amounts attributable to contributions (and increments in value thereon) made for years for which the recipient was not an owner-employee.

If an amount is not included in the amounts referred to in subdivision (i)(A) of this subparagraph solely by reason of the owner-employee's becoming disabled and if a penalty would otherwise be applicable with respect to all or a portion of such amount, then for the owner-employee's taxable year in which such amount is received, there must be submitted with his income tax return a doctor's statement as to the impairment, and a statement by the owner-employee with respect to the effect of such impairment upon his substantial gainful activity and the date such impairment occurred. For taxable years which are subsequent to the first taxable year with respect to which the statements referred to in the preceding sentence are submitted, the owner-employee may, in lieu of such statements, submit a statement declaring the continued existence (without substantial diminution) of the impairment and its continued effect upon his substantial gainful activity.

(iii) This subparagraph applies to amounts described in subdivision (i)(B) of this subparagraph (relating to benefits in excess of the plan formula) even though a portion of such amounts may be attributable to contributions made on behalf of an individual while he was not an owner-employee and even if he is deceased and the amounts are received by his successor.

(iv)(A) The rules described in subdivisions (i)(A) and (iii) of this subparagraph, relating to the treatment under section 72(m)(5)(A)(i) of certain premature distributions, may be illustrated by the following example:

Example. (*1*) A was a member of the X partnership, consisting of partners A through I, and a participant in the partnership's qualified profit-sharing plan which was established on January 1, 1972. A's taxable years, the X partnership's taxable years, the plan years, and other relevant years are all calendar years at all relevant times. For the three calendar years, 1972 through 1974, A was an owner-employee in the X partnership. On January 1, 1975, new partners J and K became partners in the X partnership, and as of that date, each of partners A through K held a 1/11 interest in the capital and profits of the X partnership. On that date, A became a partner who was not an owner-employee. A continued in this status for the 2 calendar years 1975 and 1976. On January 1, 1977, when A was 50 years old and not disabled, he liquidated his interest in the X partnership and became an employee of an unrelated employer. On that date, A received a distribution representing his entire interest in the X partnership's plan of $54,000 cash in violation of the plan provision required by section 401(d)(4)(B). As of that date, the distribution was attributable to the following sources and times, computed by the plan in a manner consistent with the subparagraph:

Calendar years	A X contributions on behalf of A deductible under sec. 404	B A's contributions made as an employee	C Increments in value attributable to column A yearly contributions	D Increments in value attributable to column B yearly contributions
1977	0	0	0	0
1976	$7,500	$2,500	$900	$300
1975	7,500	2,500	4,000	1,300
1974	7,500	2,500	1,800	700
1973	2,500	2,500	1,200	1,200
1972	2,500	2,500	1,300	1,300
Totals	27,500	12,500	9,200	4,800

(2) The amount of the $54,000 distribution to which subdivision (i)(A) of this subparagraph applies is $20,000, computed as follows:

X contributions on behalf of A made in years A was an owner-employee:	
1974	$7,500
1973	2,500
1972	2,500
Total	12,500
Increments in value attributable to such contributions:	
1974	1,800
1973	1,200
1972	1,300
Total	4,300
Increments in value attributable to contributions made by A as an employee for years in which he was an owner-employee:	
1974	700
1973	1,200
1972	1,300
Total	3,200
Grand total	20,000

In this example, the $20,000 amount computed above would be includible in A's gross income for 1977 and would be subject to the 10 percent tax described in subparagraph (1)(i) of this paragraph.

(3) Subdivision (i)(A) of this subparagraph does not apply to the contributions made by X on behalf of A for 1976 and 1975 ($7,500 each year, totaling $15,000) nor to the increments in value attributable to those contributions ($900 for 1976 and $4,000 for 1975, totaling $4,900), because A was not an owner-employee with respect to these two years, 1976 and 1975, on account of which these employer contributions were made. For the same reason, subdivision (i)(A) of this subparagraph does not apply to the increments in value attributable to A's contributions for 1976 and 1975 ($300 and $1,300, respectively, totaling $1,600).

See section 4972(c) for the amount of employee contributions which is permitted to be contributed by an owner-employee (as an employee) without subjecting an owner-employee to the tax on excess contributions.

(4) Subdivision (i)(A) of this subparagraph does not apply to the contributions made by A, as an employee during the years when he was an owner-employee ($2,500 during each of the years 1972, 1973, and 1974, totaling $7,500), because the distribution was received in a taxable year of A ending after September 2, 1974; see subparagraph (3) of this paragraph. Furthermore, because the distribution of the amount of A's contributions ($12,500) constitutes consideration for the contract paid by A for purposes of section 72, the $7,500 amount described in the preceding sentence is not includible in his gross income, and that amount is not subject to the rules of this subparagraph; see subdivision (i) of this subparagraph, and paragraphs (b) and (c) of this section.

(B) The increments in value of an individual's account may be allocated to contributions on his behalf, by his employer or by such individual as an owner-employee, while he was an owner-employee either by maintaining a separate account, or an accounting, which reflects the actual increment attributable to such contributions, or by the method described in (C) of this subdivision.

(C) Where an individual is covered under the same plan both as an owner-employee and as a non-owner-employee, the portion of the increment in value of his interest attributable to contributions made on his behalf while he was an owner-employee may be determined by multiplying the total increment in value in his account by a fraction. The numerator of the frac-

tion is the total contributions made on behalf of the individual as an owner-employee, weighted for the number of years that each contribution was in the plan. The denominator is the total contributions made on behalf of the individual, whether or not as an owner-employee, weighted for the number of years each contribution was in the plan. The contributions are weighted for the number of years in the plan by multiplying each contribution by the number of years it was in the plan. For purposes of this computation, any forfeiture allocated to the account of the individual is treated as a contribution to the account made at the time so allocated. For purposes of this computation, where the individual has received a prior distribution from such account, an appropriate adjustment must be made to reflect such prior distribution.

(D) The method described in (C) of this subdivision may be illustrated by the following example:

Example. B was a member of the XYZ Partnership and a participant in the partnership's profit-sharing plan which was created in 1973. Until the end of 1977, B's interest in the partnership was less than 10 percent. On January 1, 1978, B obtained an interest in excess of 10 percent in the partnership and continued to participate in the profit-sharing plan until 1982. During 1982, prior to the time he attained the age of 59½ years and during a time when he was not disabled, B, who had not received any prior plan distributions, withdrew his entire interest in the profit-sharing plan. At the time his interest was $15,000, $9,600 contributions and $5,400 increment attributable to the contributions. The portion of the increment attributable to contributions while B was an owner-employee is $667.80, determined as follows:

	A	B	C
	Contribution	Number of years contribution was in trust	Contribution weighted for years in trust (A × B)
1982	$1,000	0	0
1981	800	1	800
1980	1,200	2	2,400
1979	600	3	1,800
1978	200	4	800
1977	400	5	2,000
1976	2,000	6	12,000
1975	1,000	7	7,000
1974	1,500	8	12,000
1973	900	9	8,100
Total	9,600		46,900

Total weighted contributions as owner-employee (1978-1982) = $5,800.
Total weighted contributions = $46,900.

$$\$5,400 \times \frac{\$5,800}{\$46,900} = \$667.80$$

(E)(*1*) The rules set forth in subdivision (iv)(E)(*2*) of this subparagraph shall be used to determine the amounts to which subdivision (i)(A) of this subparagraph applies in the case of a distribution of less than the entire balance of the employee's account from a plan in which he has been covered at different times as owner-employee or as an employee other than an owner-employee.

(*2*) Distributions or payments from a plan for any employee taxable year shall be deemed to be attributable to contributions to the plan, and increments thereon, in the following order—

(*i*) Excess contributions, within the meaning of section 4972 (b), designated as such by the trustee;

(*ii*) Employee contributions;

(*iii*) Employer contributions, other than those described in(*i*), and the increments in value attributable to the employee's own contributions and his employer's contributions on the basis of the taxable years of his employer in succeeding order of time whether or not the employee was an owner-employee for any such year.

For purposes of (*iii*) of this subdivision, the time of contributions made on the basis of any employer taxable year shall take into account the rule specified in section 404(a)(6), relating to time when contributions deemed made.

(v) The amounts referred to in subdivision (i)(C) of this subparagraph are amounts which are received by reason of a distribution of the owner-employee's entire interest under the provisions of section 401(e)(2)(E), as in

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effect on September 1, 1974, relating to excess contributions on behalf of an owner-employee which are willfully made. Notwithstanding the preceding sentence, an owner-employee's entire interest in all plans with respect to which he is an owner-employee (within the meaning of subsections (d)(8)(C) and (e)(2)(E)(ii) of section 401, as in effect on September 1, 1974) does not include any distribution or payment attributable to his employer's contributions or his own contributions made with respect to his employer's taxable years beginning after December 31, 1975. However, his entire interest in all plans does include all of the distribution or payment attributable to his employer's contributions and his own contributions made with respect to all of his employer's taxable years beginning before January 1, 1976, if any portion thereof is attributable in whole or in part to such a willful excess contribution and such entire interest is received because of a willful excess contribution pursuant to section 401(e)(2)(E)(ii). A distribution or payment is described in the preceding sentence even though it is received in an owner-employee's taxable year beginning after December 31, 1975. For purposes of computing the increments in value attributable to employer taxable years which begin before January 1, 1976, and such increments attributable to such years beginning after December 31, 1975, the rules specified in subdivision (iv)(B), (C), (D), and (E) of this subparagraph shall be applied to the extent applicable. See § 1.401(e)-4(c) for transitional rules with respect to contributions described in this subdivision.

(3)(i) For taxable years of the recipient beginning before January 1, 1976, the tax with respect to amounts to which subparagraph (2) of this paragraph applies shall be computed under subparagraphs (B), (C), (D), and (E) of section 72(m)(5) as such subparagraphs were in effect prior to the amendments made by subsections (g)(1) and (2)(A) of section 2001 of the Employee Retirement Income Security Act of 1974 (88 Stat. 957) except as provided in subdivisions (ii) and (iii) of this subparagraph (see paragraph (e) of § 1.72-17). For purposes of the preceding sentence, amounts to which subparagraph (2) of this paragraph applies in the case of an amount described in section 72(m)(5)(A)(i) shall be determined under subdivisions (i)(*a*) and (ii) of § 1.72-17(e)(1), except as provided in subdivision (ii) of this subparagraph. For purposes of the first sentence of this subdivision, amounts to which subparagraph (2) of this paragraph applies in the case of an amount described in section 72(m)(5)(A)(ii) shall be determined under subdivisions (i)(*b*) and (iii) of § 1.72-17(e)(1), except as provided in subdivision (iii) of this subparagraph.

(ii) For purposes of applying section 72(m)(5)(A)(i), after the amendment made by section 2001(h)(3) of such Act, and subdivisions (i)(*a*) and (ii) of § 1.72-17(e)(1), to a distribution or payment received in recipient taxable years ending after September 2, 1974, and beginning before January 1, 1976, with respect to contributions made on behalf of an owner-employee which were made by him as an owner-employee (that is, employee contributions within the meaning of section 401(c)(5)(B)) the portion of any distribution or payment attributable to such contributions shall not include such contributions but shall include the increments in value attributable to such contributions.

(iii) For purposes of applying section 72(m)(5)(D) and subdivisions (i)(*b*) and (iii) of § 1.72-17(e)(1) to recipient taxable years beginning after December 31, 1973, and beginning before January 1, 1976, in the case of distributions or payments made after December 31, 1973, the amounts to which section 402 (a)(2) or 403(a)(2) applies after the amendments made by section 2005(b)(1) and (2) of such Act (88 Stat. 990 and 991) (which are amounts to which subdivision (i)(*b*) of § 1.72-17(e)(1) does not apply) shall be deemed to be the amount which is treated as a gain from the sale or exchange of a capital asset held for more than 6 months under either of such sections.

(f) *Meaning of disabled.* (1) Section 72(m)(7) provides that an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental

impairment which can be expected to result in death or to be of long-continued and indefinite duration. In determining whether an individual's impairment makes him unable to engage in any substantial gainful activity, primary consideration shall be given to the nature and severity of his impairment. Consideration shall also be given to other factors such as the individual's education, training, and work experience. The substantial gainful activity to which section 72(m)(7) refers is the activity, or a comparable activity, in which the individual customarily engaged prior to the arising of the disability or prior to retirement if the individual was retired at the time the disability arose.

(2) Whether or not the impairment in a particular case constitutes a disability is to be determined with reference to all the facts in the case. The following are examples of impairments which would ordinarily be considered as preventing substantial gainful activity:

(i) Loss of use of two limbs;

(ii) Certain progressive diseases which have resulted in the physical loss or atrophy of a limb, such as diabetes, multiple sclerosis, or Buerger's disease;

(iii) Diseases of the heart, lungs, or blood vessels which have resulted in major loss of heart or lung reserve as evidenced by X-ray, electrocardiogram, or other objective findings, so that despite medical treatment breathlessness, pain, or fatigue is produced on slight exertion, such as walking several blocks, using public transportation, or doing small chores;

(iv) Cancer which is inoperable and progressive;

(v) Damage to the brain or brain abnormality which has resulted in severe loss of judgment, intellect, orientation, or memory;

(vi) Mental diseases (e.g. psychosis or severe psychoneurosis) requiring continued institutionalization or constant supervision of the individual;

(vii) Loss or diminution of vision to the extent that the affected individual has a central visual acuity of no better than 20/200 in the better eye after best correction, or has a limitation in the fields of vision such that the widest diameter of the visual fields subtends an angle no greater than 20 degrees;

(viii) Permanent and total loss of speech;

(ix) Total deafness uncorrectible by a hearing aid.

The existence of one or more of the impairments described in this subparagraph (or of an impairment of greater severity) will not, however, in and of itself always permit a finding that an individual is disabled as defined in section 72(m)(7). Any impairment, whether of lesser or greater severity, must be evaluated in terms of whether it does in fact prevent the individual from engaging in his customary or any comparable substantial gainful activity.

(3) In order to meet the requirements of section 72(m)(7), an impairment must be expected either to continue for a long and indefinite period or to result in death. Ordinarily, a terminal illness because of disease or injury would result in disability. The term "indefinite" is used in the sense that it cannot reasonably be anticipated that the impairment will, in the foreseeable future, be so diminished as no longer to prevent substantial gainful activity. For example, an individual who suffers a bone fracture which prevents him from working for an extended period of time will not be considered disabled, if his recovery can be expected in the foreseeable future; if the fracture persistently fails to knit, the individual would ordinarily be considered disabled.

(4) An impairment which is remediable does not constitute a disability within the meaning of section 72(m)(7). An individual will not be deemed disabled if, with reasonable effort and safety to himself, the impairment can be diminished to the extent that the individual will not be prevented by the impairment from engaging in his customary or any comparable substantial gainful activity.

[T.D. 7636, 44 FR 47049, Aug. 10, 1979]

§ 1.72-18 Treatment of certain total distributions with respect to self-employed individuals.

(a) *In general.* The Self-Employed Individuals Tax Retirement Act of

1962 permits self-employed individuals to be treated as employees for purposes of participation in pension, profit-sharing, and annuity plans described in sections 401(a) and 403(a). In general, amounts received by a distributee or payee which are attributable to contributions made on behalf of a participant while he was self-employed are taxed in the same manner as amounts which are attributable to contributions made on behalf of a common-law employee. However, such amounts which are paid in one taxable year representing the total distributions payable to a distributee or payee with respect to an employee are not eligible for the capital gains treatment of section 402(a)(2) or 403(a)(2). This section sets forth the treatment of such distributions, except where such a distribution is subject to the penalties of section 72(m)(5) and paragraph (e) of § 1.72-17.

(b) *Distributions to which this section applies.* (1)(i) Except as provided in subparagraphs (2) and (3) of this paragraph, this section applies to amounts distributed to a distributee in one taxable year of the distributee in the case of an employees' trust described in section 401(a) which is exempt under section 501(a), or to amounts paid to a payee in one taxable year of the payee in the case of an annuity plan described in section 403(a), which constitute the total distributions payable, or the total amounts payable, to the distributee or payee with respect to an employee.

(ii) For the total distributions or amounts payable to a distributee or payee to be considered paid within one taxable year of the distributee or payee for purposes of this section, all amounts to the credit of the employee-participant through the end of such taxable year which are payable to the distributee or payee must be distributed or paid within such taxable year. Thus, the provisions of this section are not applicable to a distribution or payment to a distributee or payee if the trust or plan retains any amounts after the close of such taxable year which are payable to the same distributee or payee even though the amounts retained may be attributable to contributions on behalf of the employee-participant while he was a common-law employee in the business with respect to which the plan was established.

(iii) For purposes of this section, the total amounts payable to a distributee or the amounts to the credit of the employee do not include United States Retirement Plan Bonds held by a trust to the credit of the employee. Thus, a distribution to a distributee by a qualified trust may constitute a distribution to which this section applies even though the trust retains retirement plan bonds registered in the name of the employee on whose behalf the distribution is made which are to be distributed to the same distributee. Moreover, the proceeds of a retirement bond received as part of a distribution which constitutes the total distributions payable to the distributee are not entitled to the special tax treatment of this section. See section 405(d) and paragraph (a)(1) of § 1.405-3.

(iv) If the amounts payable to a distributee from a qualified trust with respect to an employee-participant includes an annuity contract, such contract must be distributed along with all other amounts payable to the distributee in order to have a distribution to which this section applies. However, the proceeds of an annuity contract received in a total distribution will not be entitled to the tax treatment of this section unless the contract is surrendered in the taxable year of the distributee in which the total distribution was received.

(v) In the case of a qualified annuity plan, the term "total amounts" means all annuities payable to a payee. If more than one annuity contract is received under the plan by a distributee, this section shall not apply to an amount received on surrender of any such contracts unless all contracts under the plan payable to the payee are surrendered within one taxable year of the payee.

(vi) (*a*) The provisions of this section are applicable where the total amounts payable to a distributee or payee are paid within one taxable year of the distributee or payee whether or not a portion of the employee-participant's interest which is payable to an-

other distributee or payee is paid within the same taxable year. However, a distributee or payee who, in prior taxable years received amounts (except amounts described in (*b*) of this subdivision) after the employee-participant ceases to be eligible for additional contributions to be made on his behalf, does not receive a distribution or payment to which this section applies, even though the total amount remaining to be paid to such distributee or payee with respect to such employee is paid within one taxable year. On the other hand, a distribution to a distributee or payee prior to the time that the employee-participant ceases to be eligible for additional contributions on his behalf does not preclude the application of this section to a later distribution to the same distributee or payee.

(*b*) The receipt of an amount which constitutes—

(*1*) A payment in the nature of a dividend or similar distribution to an individual in his capacity as a policyholder of an annuity, endowment, or life insurance contract, or

(*2*) A return of excess contributions which were not willfully made,

does not prevent the application of this section to a total distribution even though the amount is received after the employee-participant ceases to be eligible for additional contributions and in a taxable year other than the taxable year in which the total amount is received.

(vii) For purposes of this section, the total amounts payable to a distributee or payee, or the amounts to the credit of the employee, do not include any amounts which have been placed in a separate account for the funding of medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401-14. Thus, a distribution by a qualified trust or annuity plan may constitute a distribution to which this section applies even though amounts attributable to the funding of section 401(h) medical benefits as defined in paragraph (a) of § 1.401-14 are not so distributed.

(2) This section shall apply—

(i) Only if the distribution or payment is made—

(*a*) On account of the employee's death at any time,

(*b*) After the employee has attained the age 59½ years, or

(*c*) After the employee has become disabled; and

(ii) Only to so much of the distribution or payment as is attributable to contributions made on behalf of an employee while he was a self-employed individual in the business with respect to which the plan was established. Any distribution or payment, or any portion thereof, which is not so attributable shall be subject to the rules of taxation which apply to any distribution or payment that is attributable to contributions on behalf of common-law employees.

For taxable years beginning after December 31, 1966, see section 72(m)(7) and paragraph (f) of § 1.72-17 for the meaning of disabled. For taxable years beginning before January 1, 1967, see section 213(g)(3) for the meaning of disabled. For taxable years beginning after December 31, 1968, if this section is applicable by reason of the distribution or payment being made after the employee has become disabled, then for the taxable year in which the amounts to which this section applies are distributed or paid, there shall be submitted with the recipient's income tax return a doctor's statement as to the nature and effect of the employee's impairment.

(3) This section shall not apply to—

(i) Distributions or payments to which the penalty provisions of section 72(m)(5) and paragraph (e) of § 1.72-17 apply,

(ii) Distributions or payments from a trust or plan made to or on behalf of an individual prior to the time such individual ceases to be eligible for additional contributions (except the contribution attributable to the last year of service) to be made to the trust or plan on his behalf as a self-employed individual, and

(iii) Distributions or payments made to the employee from a plan or trust unless contributions which were allowed as a deduction under section 404 have been made on behalf of such employee as a self-employed individual under such trust or plan for 5 or more

taxable years (whether or not consecutive) prior to the taxable year in which such distributions or payments are made. Distributions or payments to which this section does not apply by reason of this subdivision are taxed as otherwise provided in section 72. However, for taxable years beginning before January 1, 1964, section 72(e)(3), as in effect before such date, is not applicable. For taxable years beginning after December 31, 1963, such distributions or payments may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(4) The portion of any distribution or payment attributable to contributions on behalf of an employee-participant while he was self-employed includes the contributions made on his behalf while he was self-employed and the increments in value attributable to such contributions. Where the amounts to the credit of an employee-participant include amounts attributable to contributions on his behalf while he was a self-employed individual and amounts attributable to contributions on his behalf while he was a common-law employee, the increment in value attributable to the employee-participant's interest shall be allocated to the contributions on his behalf while he was self-employed either by maintaining a separate account, or an accounting, which reflects the actual increment attributable to such contributions, or by the method described in paragraph (e)(1)(iv)(*c*) of § 1.72-17. However, if the latter method is used, the numerator of the fraction is the total contributions made on behalf of the individual as a self-employed individual, weighted for the number of years that each contribution was in the plan.

(c) *Amounts includible in gross income.* (1) Where a total distribution or payment to which this section applies is made to one distributee or payee and includes the total amount remaining to the credit of the employee-participant on whose behalf the distribution or payment was made, the distributee or payee shall include in gross income an amount equal to the portion of the distribution or payment which exceeds the employee-participant's investment in the contract. For purposes of this paragraph, the investment in the contract shall be reduced by any amounts previously received from the plan or trust by or on behalf of the employee-participant which were excludable from gross income as a return of the investment in the contract.

(2) In the case of a distribution to which this section applies and which is made to more than one distributee or payee, each element of the amounts to the credit of an employee-participant shall be allocated among the several distributees or payees on the basis of the ratio of the value of the distributee's or payee's distribution or payment to the total amount to the credit of the employee-participant. The elements to be so allocated include the investment in the contract, the increments in value, and the portion of the amounts to the credit of the employee-participant which is attributable to the contributions on behalf of the employee-participant while he was a self-employed individual.

(d) *Computation of tax.* (1) The tax attributable to the amounts to which this section applies for the taxable year in which such amounts are received is the greater of—

(i) 5 times the increase in tax which would result from the inclusion in gross income of the recipient of 20 percent of so much of the amount so received as is includible in gross income, or

(ii) 5 times the increase which would result if the taxable income of the recipient for such taxable year equaled 20 percent of the excess of the aggregate of the amounts so received and includible in gross income over the amount of the deductions allowed the recipient for such taxable year under section 151 (relating to deduction for personal exemptions).

In any case in which the application of subdivision (ii) of this subparagraph results in an increase in taxable income for any taxable year, the resulting increase in taxes imposed by section 1 or 3 for such taxable year shall be reduced by the credit against tax provided by section 31 (tax with-

held on wages), but shall not be reduced by any other credits against tax.

(2) The application of the rules of this paragraph may be illustrated by the following example:

Example. B, a sole proprietor and a calendar-year basis taxpayer, established a qualified pension trust to which he made annual contributions for 10 years of 10 percent of his earned income. B withdrew his entire interest in the trust during 1973, for which year, without regard to the distribution, he had a net operating loss and is allowed under section 151 a deduction for one personal exemption. At the time of the withdrawal, B was 64 years old. The amount of the distribution that is includible in his gross income is $25,750. Because of B's net operating loss, the tax attributable to the distribution is determined under the rule of subparagraph (1)(ii) of this paragraph. For purposes of determining the tax attributable to the $25,750, B's taxable income for 1973 is treated, under subparagraph (1)(ii) of this paragraph, as being 20 percent of $25,000 ($25,750 minus $750, the amount of the deduction allowed for each personal exemption under section 151 for 1973). Thus, under subparagraph (1) of this paragraph, the tax attributable to the $25,750 would be 5 times the increase which would result if the taxable income of B for the taxable year he received such amount equaled $5,000. B has had no amounts withheld from wages and thus is not entitled to reduce the increase in taxes by the credit against tax provided in section 31 and may not reduce the increase in taxes by any other credits against tax.

[T.D. 6676, 28 FR 10138, Sept. 17, 1963, as amended by T.D. 6722, 29 FR 5070, Apr. 14, 1964, T.D. 6885, 31 FR 7800, June 2, 1966, T.D. 6985, 33 FR 19812, Dec. 27, 1968; T.D. 7114, 36 FR 9018, May 18, 1971]

§ 1.73–1 Services of child.

(a) Compensation for personal services of a child shall, regardless of the provisions of State law relating to who is entitled to the earnings of the child, and regardless of whether the income is in fact received by the child, be deemed to be the gross income of the child and not the gross income of the parent of the child. Such compensation, therefore, shall be included in the gross income of the child and shall be reflected in the return rendered by or for such child. The income of a minor child is not required to be included in the gross income of the parent for income tax purposes. For requirements for making the return by such child, or for such child by his guardian, or other person charged with the care of his person or property, see section 6012.

(b) In the determination of taxable income or adjusted gross income, as the case may be, all expenditures made by the parent or the child attributable to amounts which are includible in the gross income of the child and not of the parent solely by reason of section 73 are deemed to have been paid or incurred by the child. In such determination, the child is entitled to take deductions not only for expenditures made on his behalf by his parent which would be commonly considered as business expenses, but also for other expenditures such as charitable contributions made by the parent in the name of the child and out of the child's earnings.

(c) For purposes of section 73, the term "parent" includes any individual who is entitled to the services of the child by reason of having parental rights and duties in respect of the child. See section 6201(c) and the regulations in Part 301 of this chapter (Procedure and Administration) for assessment of tax against the parent in certain cases.

§ 1.74–1 Prizes and awards.

(a) *Inclusion in gross income.* (1) Section 74(a) requires the inclusion in gross income of all amounts received as prizes and awards, unless such prizes or awards qualify as an exclusion from gross income under subsection (b), or unless such prize or award is a scholarship or fellowship grant excluded from gross income by section 117. Prizes and awards which are includible in gross income include (but are not limited to) amounts received from radio and television giveaway shows, door prizes, and awards in contests of all types, as well as any prizes and awards from an employer to an employee in recognition of some achievement in connection with his employment.

(2) If the prize or award is not made in money but is made in goods or services, the fair market value of the

goods or services is the amount to be included in income.

(b) *Exclusion from gross income.* Section 74(b) provides an exclusion from gross income of any amount received as a prize or award, if (1) such prize or award was made primarily in recognition of past achievements of the recipient in religious, charitable, scientific, educational, artistic, literary, or civic fields; (2) the recipient was selected without any action on his part to enter the contest or proceedings; and (3) the recipient is not required to render substantial future services as a condition to receiving the prize or award. Thus, such awards as the Nobel prize and the Pulitzer prize would qualify for the exclusion. Section 74(b) does not exclude prizes or awards from an employer to an employee in recognition of some achievement in connection with his employment.

(c) *Scholarships and fellowship grants.* See section 117 and the regulations thereunder for provisions relating to scholarships and fellowship grants.

§ 1.75–1 Treatment of bond premiums in case of dealers in tax-exempt securities.

(a) *In general.* (1) Section 75 requires certain adjustments to be made by dealers in securities with respect to premiums paid on municipal bonds which are held for sale to customers in the ordinary course of the trade or business. The adjustments depend upon the method of accounting used by the taxpayer in computing the gross income from the trade or business. See paragraphs (b) and (c) of this section.

(2) The term "municipal bond" under section 75 means any obligation issued by a government or political subdivision thereof if the interest on the obligation is excludable from gross income under section 103. However, such term does not include an obligation—

(i) If the earliest maturity or call date of the obligation is more than 5 years from the date of acquisition by the taxpayer or the obligation is sold or otherwise disposed of by the taxpayer within 30 days after the date of acquisition by him, and

(ii) If, in case of an obligation acquired after December 31, 1957, the amount realized upon its sale (or, in the case of any other disposition, its fair market value at the time of disposition) is higher than its adjusted basis.

For purposes of this subparagraph, the amount realized on the sale of the obligation, or the fair market value of the obligation, shall not include any amount attributable to interest, and the adjusted basis shall be computed without regard to any adjustment for amortization of bond premium required under section 75 and section 1016(a)(6). For purposes of determining whether the obligation is sold or otherwise disposed of by the taxpayer within 30 days after the date of its acquisition by him, it is immaterial whether or not such 30-day period is entirely within one taxable year.

(3) The term "cost of securities sold" means the amount ascertained by subtracting the inventory value of the closing inventory of a taxable year from the sum of the inventory value of the opening inventory for such year and the cost of securities and other property purchased during such year which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

(b) *Inventories not valued at cost.* (1) In the case of a dealer in securities who computes gross income from his trade or business by the use of inventories and values such inventories on any basis other than cost, the adjustment required by section 75 is, except as provided in subparagraph (2) of this paragraph, the reduction of "cost of securities sold" by the amount equal to the amortizable bond premium which would be disallowed as a deduction under section 171(a)(2) with respect to the municipal bond if the dealer were an ordinary investor holding such bond. Such amortizable bond premium is computed under section 171(b) by reference to the cost or other original basis of the bond on the date of acquisition (determined without regard to section 1013, relating to inventory value on a subsequent date).

(2) With respect to an obligation acquired after December 31, 1957, which

has as its earliest maturity or call date a date more than five years from the date on which it was acquired by the taxpayer, the following rules shall apply:

(i) If the taxpayer holds the obligation at the end of the taxable year, he is not required by section 75 to reduce the "cost of securities sold" for such year with respect to the obligation.

(ii) If the taxpayer sells or otherwise disposes of the obligation during the taxable year, he shall reduce the "cost of securities sold" for the taxable year of the sale or disposition unless he sold the obligation for more than its adjusted basis or otherwise disposed of it when its fair market value was more than its adjusted basis. For purposes of determining whether or not the taxpayer sold the obligation for more than its adjusted basis, or otherwise disposed of it when its fair market value was more than its adjusted basis, the amount realized on the sale of the obligation, or the fair market value of the obligation, shall not include any amount attributable to interest, and the adjusted basis shall be computed without regard to any adjustment for amortization of bond premium required under sections 75 and 1016(a)(6). The amount of the reduction referred to in the first sentence of this subdivision is the total amount by which the adjusted basis of the obligation would be required to be reduced under section 1016(a)(5) were the obligation subject to the amortizable bond premium provisions of section 171; that is, the amount of the amortizable bond premium attributable to the period during which the obligation was held which would be disallowed as a deduction under section 171(a)(2) if the taxpayer were an ordinary investor.

(3) This paragraph may be illustrated by the following examples:

Example (1). X, a dealer in securities who values his inventories on a basis other than cost, makes his income tax returns on the calendar year basis. On July 1, 1954, he bought, for $1,060 each, three municipal bonds (A, B, an C) having a face obligation of $1,000, and maturing on July 1, 1959. Bond A is sold on December 31, 1954, bond B is sold on December 31, 1955, and bond C is sold on June 30, 1956. For each bond the amortizable bond premium to maturity is $60, the period from date of acquisition to maturity is 60 months, and the amortizable bond premium per month is $1. The adjustment for each of the years 1954, 1955, and 1956 is as follows:

Bond	Date acquired	Date sold	Adjustment to "cost of securities sold" for—		
			1954	1955	1956
A	July 1, 1954	Dec. 31, 1954	$6		
B	July 1, 1954	Dec. 31, 1955	6	$12	
C	July 1, 1954	Jun. 30, 1956	6	12	$6
Total			18	24	6

Example (2). Y is a dealer in securities who values his inventories on a basis other than cost. He makes his income tax returns on the calendar year basis. On January 1, 1958, Y bought five bonds (D, E, F, G, and H) issued by various municipalities. Each bond has a face obligation of $1,000 and was purchased for $1,060. The interest on each is excludable from gross income under section 103. Bonds D, E, and F mature on December 31, 1962, and bonds G and H mature on December 31, 1967. The amortizable bond premium per month is $1 with respect to bonds D, E, and F, and is $.50 with respect to bonds G and H. The following table indicates the reduction in "cost of securities sold" which Y should make for the years shown, assuming that he sells the bonds on the dates and for the prices set forth:

Bond	Date sold	Sale price	Adjustment to "cost of securities sold" for—		
			1958	1959	1960
D	Feb. 1, 1959	$1,090	$12	$1	
E	Jan. 30, 1958	1,100	None		

Bond	Date sold	Sale price	Adjustment to "cost of securities sold" for—		
			1958	1959	1960
F	Jan. 30, 1958	1,000	1		
G	Dec. 31, 1960	1,065	None	None	None
H	Dec. 31, 1960	1,050	None	None	$18
Total			13	1	18

An adjustment to "cost of securities sold" must be made with respect to bond D (even though it was ultimately sold at a gain) because the bond neither had an earliest maturity or call date of more than 5 years from the date on which Y acquired it, nor was it disposed of within 30 days after such date. An adjustment must be made for the years 1958 and 1959 since section 75(a)(1) requires that an adjustment be made with respect to such a bond at the close of each taxable year in which it is held. On the other hand, since bonds E, F, G, and H either were disposed of within 30 days after the date of such acquisition or had an earliest maturity or call date more than 5 years from the date of acquisition, and were acquired after December 31, 1957, it is necessary to determine whether Y disposed of them at a loss so as to require an adjustment under section 75. No adjustment is necessary with respect to bonds E and G because they were sold at a gain. An adjustment to "cost of securities sold" is required with respect to bonds F and H because they were sold at a loss. As in the case of bond D, an adjustment with respect to bond F is made in 1958 in accordance with section 75(a)(1); however, the adjustment with respect to bond H is made entirely in 1960, the taxable year in which Y sold that bond, in accordance with the last sentence of section 75(a). If Y had acquired bonds before January 1, 1958, it would be unnecessary to determine whether they were disposed of at a loss since that factor is significant only with respect to bonds acquired on or after that date.

(c) *Inventories not used or inventories valued at cost.* (1) In the case of a dealer in securities who computes gross income from his trade or business without the use of inventories or by use of inventories valued at cost, the adjustment required by section 75 is a reduction of the adjusted basis of each municipal bond sold or otherwise disposed of during the taxable year. The amount of such reduction is the total amount by which the adjusted basis of the bond would be required to be reduced under section 1016(a)(5) were the bond subject to the amortizable bond premium provisions of section 171; that is, the amount of the amortizable bond premium attributable to the period during which the bond was held which would be disallowed as a deduction under section 171(a)(2) if the taxpayer were an ordinary investor.

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Z, a dealer in securities who values his inventories on the basis of cost, makes his income tax returns on the calendar year basis. On January 1, 1954, he buys, for $1,060 each, three municipal bonds (I, J, and K) having a face obligation of $1,000, and maturing on January 1, 1959. Bond I is sold on December 31, 1954, bond J is sold on June 30, 1955, and bond K is sold on December 31, 1956. For each bond, the amortizable bond premium to maturity is $60, the period from the date of acquisition to maturity is 60 months, and the amortizable bond premium per month is $1.

Bond	Date acquired	Date sold	Adjustment for—		
			1954	1955	1956
I	Jan. 1, 1954	Dec. 31, 1954	$12		
J	Jan. 1, 1954	June 30, 1955	None	$18	
K	Jan. 1, 1954	Dec. 31, 1956	None	None	$36

(d) *Bonds acquired before July 1, 1950.* Under section 203(c) of the Revenue Act of 1950, adjustment is required for a municipal bond acquired before July 1, 1950, only with respect to taxable years beginning on or after

that date. Accordingly, if the municipal bond was acquired before July 1, 1950, then for purposes of section 75 the amortizable bond premium under section 171 must be computed after adjusting the bond premium to the extent proper to reflect unamortized bond premium for so much of the holding period (as determined under section 1223) as precedes the taxable year of the dealer beginning on or after July 1, 1950. Thus, in example (1) of paragraph (b) and in the example in paragraph (c) of this section, the first taxable year beginning on or after July 1, 1950, is, for each dealer, the taxable year beginning January 1, 1951. If each dealer had purchased for $1,060 on April 1, 1950, a municipal bond having a face obligation of $1,000 and maturing April 1, 1955, and had sold such bond on February 28, 1955, the adjustment under section 75 would be computed as follows:

	Dealer X	Dealer Z
Bond premium	$60	$60
Adjustment for holding period prior to Jan. 1, 1951	9	9
Amortizable bond premium to maturity, as adjusted	51	51
Amortizable bond premium per month	1	1
Total adjustments under sec. (o), 1939 Code, for years 1951-53	36	None
Adjustment under sec. 75 for 1954	12	None
Adjustment under sec. 75 for 1955	2	50

[T.D. 6647, 28 FR 3519, Apr. 11, 1963]

§ 1.77-1 Election to consider Commodity Credit Corporation loans as income.

A taxpayer who receives a loan from the Commodity Credit Corporation may, at his election, include the amount of such loan in his gross income for the taxable year in which the loan is received. If a taxpayer makes such an election (or has made such an election under section 123 of the Internal Revenue Code of 1939 or under section 223(d) of the Revenue Act of 1939 (53 Stat. 897)), then for subsequent taxable years he shall include in his gross income all amounts received during those years as loans from the Commodity Credit Corporation, unless he secures the permission of the Commissioner to change to a different method of accounting. Application for permission to change such method of accounting and the basis upon which the return is made shall be filed with the Commission of Internal Revenue, Washington, D.C. 20224, within 90 days after the beginning of the taxable year to be covered by the return.

§ 1.77-2 Effect of election to consider commodity credit loans as income.

(a) If a taxpayer elects or has elected under section 77, section 123 of the Internal Revenue Code of 1939, or section 223(d) of the Revenue Act of 1939 (53 Stat. 897), as amended, to include in his gross income the amount of a loan from the Commodity Credit Corporation for the taxable year in which it is received, then—

(1) No part of the amount realized by the Commodity Credit Corporation upon the sale or other disposition of the commodity pledged for such loan shall be recognized as income to the taxpayer, unless the taxpayer receives an amount in addition to that advanced to him as the loan, in which event such additional amount shall be included in the gross income of the taxpayer for the taxable year in which it is received, and

(2) No deductible loss to the taxpayer shall be recognized on account of any deficiency realized by the Commodity Credit Corporation on such loan if the taxpayer was relieved from liability for such deficiency.

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example. A, a taxpayer who elected for his taxable year 1952 to include in gross income amounts received as loans from the Commodity Credit Corporation, received as loans $500 in 1952, $700 in 1953, and $900 in 1954. In 1956 all the pledged commodity was sold by the Commodity Credit Corporation for an amount $100 and $200 less than the loans with respect to the commodity pledged in 1952 and 1953, respectively, and for an amount $150 greater than the loan with respect to the commodity pledged in 1954. A, in making his return for 1956, shall include in gross income the sum of $150 if it is received during that year, but will not be allowed a deduction for the deficiencies of $100 and $200 unless he is required to satis-

fy such deficiencies and does satisfy them during that year.

§ 1.78–1 Dividends received from certain foreign corporations by certain domestic corporations choosing the foreign tax credit.

(a) *Taxes deemed paid by certain domestic corporations treated as a section 78 dividend.* If a domestic corporation chooses to have the benefits of the foreign tax credit under section 901 for any taxable year, an amount which is equal to the foreign income taxes deemed to be paid by such corporation for such year under section 902(a) in accordance with §§ 1.902–1 and 1.902–2 and § 1.902(b)(2), or under section 960(a)(1) in accordance with § 1.960–7, shall, to the extent provided by this section, be treated as a dividend (hereinafter referred to as a section 78 dividend) received by such domestic corporation from the foreign corporation described in section 902(a) in accordance with §§ 1.902–1 and 1.902–2 or section 960(c)(1) in accordance with § 1.960–7, as the case may be. A section 78 dividend shall be treated as a dividend for all purposes of the Code, except that it shall not be treated as a dividend under section 245, relating to dividends received from certain foreign corporations, or increase the earnings and profits of the domestic corporation. For purposes of determining the source of a section 78 dividend in computing the limitation on the foreign tax credit under section 904, see § 1.902(h)(1) and the regulations under section 960. For special rules relating to the determination of the foreign tax credit under section 902 with respect to certain minimum distributions received from controlled foreign corporations and the effect of such rules upon the gross-up under section 78, see paragraph (c) of § 1.963–4. For rules respecting the reduction of foreign income taxes under section 6038(b) in applying section 902(a) in accordance with §§ 1.902–1 and 1.902–2 or section 960(c)(1) in accordance with § 1.960–7, where there has been a failure to furnish certain information and for an illustration of the effect of such reduction upon the amount of a section 78 dividend, see paragraph (l) of § 1.6038–2.

(b) *Certain taxes not treated as a section 78 dividend.* Foreign income taxes deemed paid by a domestic corporation under section 902(a) in accordance with §§ 1.902–1 and 1.902–2 or section 960(c)(1) in accordance with § 1.960–7, shall not, to the extent provided by paragraph (b) of § 1.960–3, be treated as a section 78 dividend where such taxes are imposed on certain distributions from the earnings and profits of a controlled foreign corporation attributable to an amount which is, or has been, included in gross income of the domestic corporation under section 951.

(c) *United Kingdom income tax included in gross income under treaty.* Any amount of United Kingdom income tax appropriate to a dividend paid by a corporation which is a resident of the United Kingdom shall not be treated as a section 78 dividend by a domestic corporation to the extent that such tax is included in the gross income of such domestic corporation in accordance with Article XIII (1) of the income tax convention between the United States and the United Kingdom, as amended by Article II of the supplementary protocol between such Governments signed on August 19, 1957 (9 UST 1331). See § 507.117 of this chapter, relating to credit against United States tax liability for income tax paid or deemed to have been paid to the United Kingdom.

(d) *Taxable year in which section 78 dividend is received.* A section 78 dividend shall be considered received in the taxable year of a domestic corporation in which—

(1) The corporation receives the dividend by reason of which there are deemed paid under section 902(a) in accordance with §§ 1.902–1 and 1.902–2 the foreign income taxes which give rise to such section 78 dividend, or

(2) The corporation includes in gross income under section 951(a) the amounts by reason of which there are deemed paid under section 960(a)(1) in accordance with § 1.960–7 the foreign income taxes which give rise to such section 78 dividend, notwithstanding that such foreign income taxes may be carried back or carried over to another

taxable year under section 904(d) and are deemed to be paid or accrued in such other taxable year.

(e) *Effective dates for the application of section 78*—(1) *In general.* This section shall apply to amounts of foreign income taxes deemed paid under section 902(a) in accordance with §§ 1.902-1 and 1.902-2, or under section 960(a)(1) in accordance with § 1.960-7, by reason of a distribution received by a domestic corporation—

(i) After December 31, 1964, or

(ii) Before January 1, 1965, in a taxable year of such domestic corporation beginning after December 31, 1962, but only to the extent that such distribution is made out of the accumulated profits of a foreign corporation for a taxable year of such foreign corporation beginning after December 31, 1962.

For special rules relating to determination of accumulated profits for such purposes, see the regulation under section 902.

(2) *Amounts under section 951 treated as distributions.* For purposes of this paragraph, any amount attributable to the earnings and profits for the taxable year of a first-tier corporation (as defined in paragraph (b)(1) of § 1.960-1) which is included in the gross income of a domestic corporation under section 951(a) shall be treated as a distribution received by such domestic corporation on the last day in such taxable year on which such first-tier corporation is a controlled foreign corporation.

(f) *Illustrations.* The application of this section may be illustrated by the examples provided in § 1.902-1, § 1.904-5, § 1.960-3, § 1.960-4, and § 1.963-4.

[T.D. 6805, 30 FR 3208, Mar. 9, 1965, as amended by T.D. 7120, 36 FR 10859, June 4, 1971; 36 FR 11924, June 23, 1971; T.D. 7481, 42 FR 20130, Apr. 18, 1977; T.D. 7490; 42 FR 30497, June 15, 1977; 42 FR 32536, June 27, 1977; T.D. 7649, 44 FR 60086, Oct. 18, 1979]

§ 1.79-0 Group-term life insurance—definitions of certain terms.

The following definitions apply for purposes of section 79, this section, and §§ 1.79-1, 1.79-2, and 1.79-3.

Carried directly or indirectly. A policy of life insurance is "carried directly or indirectly" by an employer if—

(a) The employer pays any part of the cost of the life insurance directly or through another person; or

(b) The employer or two or more employers arrange for payment of the cost of the life insurance by their employees and charge at least one employee less than the cost of his or her insurance, as determined under Table I of § 1.79-3(d)(2), and at least one other employee more than the cost of his or her insurance, determined in the same way.

Employee. An "employee" is—

(a) A person who performs services if his or her relationship to the person for whom services are performed is the legal relationship of employer and employee described in § 31.3401(c)-1; or

(b) A full-time life insurance salesperson described in section 7701(a)(20); or

(c) A person who formerly performed services as an employee.

A person who formerly performed services as an employee and currently performs services for the same employer as an independent contractor is considered an employee only with respect to insurance provided because of the person's former services as an employee.

Group of employees. A "group of employees" is all employees of an employer, or less than all employees if membership in the group is determined solely on the basis of age, marital status, or factors related to employment. Examples of factors related to employment are membership in a union some or all of whose members are employed by the employer, duties performed, compensation received, and length of service. Ordinarily the purchase of something other than group-term life insurance is not a factor related to employment. For example, if an employer provides credit life insurance to all employees who purchase automobiles, these employees are not a "group of employees" because membership is not determined solely on the basis of age, marital status, or factors related to employment. On the other hand, participation in an employer's pension, profit-

sharing or accident and health plan is considered a factc. related to employment even if employees are required to contribute to the cost of the plan. Ownership of stock in the employer corporation is not a factor related to employment. However, participation in an employer's stock bonus plan may be a factor related to employment and a "group of employees" may include employees who own stock in the employer corporation.

Permanent benefit. A "permanent benefit" is an economic value extending beyond one policy year (for example, a paid-up or cash surrender value) that is provided under a life insurance policy. However, the following features are not permanent benefits:

(a) A right to convert (or continue) life insurance after group life insurance coverage terminates;

(b) Any other feature that provides no economic benefit (other than current insurance protection) to the employee; or

(c) A feature under which term life insurance is provided at a level premium for a period of five years or less.

Policy. The term "policy" includes two or more obligations of an insurer (or its affiliates) that are sold in conjunction. Obligations that are offered or available to members of a group of employees are sold in conjunction if they are offered or available because of the employment relationship. The actuarial sufficiency of the premium charged for each obligation is not taken into account in determining whether the obligations are sold in conjunction. In addition, obligations may be sold in conjunction even if the obligations are contained in separate documents, each document is filed with and approved by the applicable state insurance commission, or each obligation is independent of any other obligation. Thus, a group of individual contracts under which life insurance is provided to a group of employees may be a policy. Similarly, two benefits provided to a group of employees, one term life insurance and the other a permanent benefit, may be a policy, even if one of the benefits is provided only to employees who decline the other benefit.

[T.D. 7623, 44 FR 28797, May 17, 1979]

§ 1.79–1 Group-term life insurance—general rules.

(a) *What is group-term life insurance?* Life insurance is not group-term life insurance for purposes of section 79 unless it meets the following conditions: (1) It provides a general death benefit that is excludable from gross income under section 101(a).

(2) It is provided to a group of employees.

(3) It is provided under a policy carried directly or indirectly by the employer.

(4) The amount of insurance provided to each employee is computed under a formula that precludes individual selection. This formula must be based on factors such as age, years of service, compensation, or position. This condition may be satisfied even if the amount of insurance provided is determined under a limited number of alternative schedules that are based on the amount each employee elects to contribute. However, the amount of insurance provided under each schedule must be computed under a formula that precludes individual selection.

(b) *May group-term life insurance be combined with other benefits?* (1) No part of the life insurance provided under a policy that provides a permanent benefit is group-term life insurance unless—

(i) The policy or the employer designates in writing the part of the death benefit provided to each employee that is group-term life insurance;

(ii) The part of the death benefit that is provided to an employee and designated as the group-term life insurance benefit for any policy year is not less than the difference between the total death benefit provided under the policy and the employee's deemed death benefit (DDB) at the end of the policy year determined under paragraph (d)(3) of this section;

(iii) Employees may elect to decline or drop the permanent benefit; and

(iv) The death benefit designated as group-term life insurance that is provided to any employee is not reduced because of that employee's election to decline or drop the permanent benefit.

(2) The condition of paragraph (b)(1)(iv) of this section is illustrated by the following examples:

Example (1). A policy permits each employee of an employer to purchase units of paid-up whole life insurance. If an employee purchases the paid-up insurance, the policy also provides current life insurance so that a total death benefit of $10,000 is provided to the employee. If the employee does not purchase the paid-up insurance, the policy provides no current life insurance. The policy designates the current life insurance as group-term life insurance. However, none of the current life insurance is group-term life insurance for purposes of section 79 because the current life insurance is reduced if an employee elects to decline or drop the permanent benefit.

Example (2). A policy permits each employee to purchase units of paid-up whole life insurance but provides $10,000 of current life insurance to each employee whether or not the employee purchases the units of paid-up whole life insurance. The current life insurance is group-term life insurance for purposes of section 79 if all other requirements of section 79 are met.

Example (3). A policy permits each employee to purchase a $100 unit of paid-up whole life insurance in each policy year. In the first policy year an employee is insured, the policy provides $10,000 of current life insurance. In each subsequent policy year, the amount of current life insurance provided is reduced by $100 whether or not the employee purchases a unit of paid-up whole life insurance. The current life insurance is group-term life insurance for purposes of section 79 if all other requirements of section 79 are met.

Example (4). The facts are the same as example (3) except that the amount of current life insurance provided to employees who do not purchase the paid-up whole life insurance is not reduced. Thus, these employees receive $10,000 of current life insurance in each policy year. The current life insurance is group-term life insurance for purposes of section 79 if all other requirements of section 79 are met.

(c) *May a group include fewer than 10 employees?* (1) As a general rule, life insurance provided to a group of employees cannot qualify as group-term life insurance for purposes of section 79 unless, at some time during the calendar year, it is provided to at least 10 full-time employees who are members of the group of employees. For purposes of this rule, all life insurance provided under policies carried directly or indirectly by the employer is taken into account in determining the number of employees to whom life insurance is provided.

(2) The general rule of paragraph (c)(1) of this section does not apply if the following conditions are met:

(i) The insurance is provided to all full-time employees of the employer or, if evidence of insurability affects eligibility, to all full-time employees who provide evidence of insurability satisfactory to the insurer.

(ii) The amount of insurance provided is computed either as a uniform percentage of compensation or on the basis of coverage brackets established by the insurer. However, the amount computed under either method may be reduced in the case of employees who do not provide evidence of insurability satisfactory to the insurer. In general, no bracket may exceed 2½ times the next lower bracket and the lowest bracket must be at least 10 percent of the highest bracket. However, the insurer may establish a separate schedule of coverage brackets for employees who are over age 65, but no bracket in the over-65 schedule may exceed 2½ times the next lower bracket and the lowest bracket in the over-65 schedule must be at least 10 percent of the highest bracket in the basic schedule.

(iii) Evidence of insurability affecting employee's eligibility for insurance or the amount of insurance provided to that employee is limited to a medical questionnaire completed by the employee that does not require a physical examination.

(3) The general rule of paragraph (c)(1) of this section does not apply if the following conditions are met:

(i) The insurance is provided under a common plan to the employees of two or more unrelated employers.

(ii) The insurance is restricted to, but mandatory for, all employees of the employer who belong to or are represented by an organization (such as a union) that carries on substantial activities in addition to obtaining insurance.

(iii) Evidence of insurability does not affect an employee's eligibility for insurance or the amount of insurance provided to that employee.

(4) For purposes of paragraph (c) (2) and (3) of this section, employees are

not taken into account if they are denied insurance for the following reasons:

(i) They are not eligible for insurance under the terms of the policy because they have not been employed for a waiting period, specified in the policy, which does not exceed six months.

(ii) They are part-time employees. Employees whose customary employment is for not more than 20 hours in any week, or 5 months in any calendar year, are presumed to be part-time employees.

(iii) They have reached the age of 65.

(5) For purposes of paragraph (c) (1) and (2) of this section, insurance is considered to be provided to an employee who elects not to receive insurance.

(d) *How much must an employee receiving permanent benefits include in income?*—(1) *In general.* If an insurance policy that meets the requirements of this section provides permanent benefits to an employee, the cost of the permanent benefits reduced by the amount paid for permanent benefits by the employee is included in the employee's income. The cost of the permanent benefits is determined under the formula in paragraph (d)(2) of this section.

(2) *Formula for determining cost of the permanent benefits.* In each policy year the cost of the permanent benefits for any particular employee must be no less than:

$$X(DDB_2-DDB_1)$$

where

DDB_2 is the employee's deemed death benefit at the end of the policy year;

DDB_1 is the employee's deemed death benefit at the end of the preceding policy year; and

X is the net single premium for insurance (the premium for one dollar of paid-up whole-life insurance) at the employee's attained age at the beginning of the policy year.

(3) *Formula for determining deemed death benefit.* The deemed death benefit (DDB) at the end of any policy year for any particular employee is equal to:

$$R/Y$$

where

R is the net level premium reserved at the end of that policy year for all benefits provided to the employee by the policy or, if greater, the cash value of the policy at the end of that policy year; and

Y is the net single premium for insurance (the premium for one dollar of paid-up whole life insurance) at the employee's age at the end of that policy year.

(4) *Mortality tables and interest rates used.* For purposes of paragraph (d) (2) and (3) of this section, the net level premium reserve (R) and the net single premium (X or Y) shall be based on the 1958 CSO Mortality Table and 4 percent interest.

(5) *Dividends.* If an insurance policy that meets the requirements of this section provides permanent benefits, part or all of the dividends under the policy may be includible in the employee's income. If the employee pays nothing for the permanent benefits, all dividends under the policy that are actually or constructively received by the employee are includible in the employee's income. In all other cases, the amount of dividends included in the employee's income is equal to

$$(D+C)-(PI+DI+AP)$$

where

D is the total amount of dividends actually or constructively received under the policy by the employee in the current and all preceding taxable years of the employee;

C is the total cost of the permanent benefits for the current and all preceding taxable years of the employee determined under the formulas in paragraph (d) (2) and (6) of this section:

PI is the total amount of premium included in the employee's income under paragraph (d)(1) of this section for the current and all preceding taxable years of the employee;

DI is the total amount of dividends included in the employee's income under this paragraph (d)(5) in all preceding taxable years of the employee; and

AP is the total amount paid for permanent benefits by the employee in the current and all preceding taxable years of the employee.

(6) *Different policy and taxable years.* (i) If a policy year begins in one employee taxable year and ends in another employee taxable year, the cost of the permanent benefits, determined under the formula in paragraph (d)(2)

of this section, is allocated between the employee taxable years.

(ii) The cost of permanent benefits for a policy year is allocated first to the employee taxable year in which the policy year begins. The cost of permanent benefits allocated to that policy year is equal to:

$F \times C$

where

F is the fraction of the premium for that policy year that is paid on or before the last day of the employee taxable year; and

C is the cost of permanent benefits for the policy year determined under the formula in paragraph (d)(2) of this section.

(iii) Any part of the cost of permanent benefits that is not allocated to the employee taxable year in which the policy year begins is allocated to the subsequent employee taxable year.

(iv) The cost of permanent benefits for an employee taxable year is the sum of the costs of permanent benefits allocated to that year under paragraph (d)(6) (ii) and (iii) of this section.

(7) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. An employer provides insurance to employee A under a policy that meets the requirements of this section. Under the policy, A who is 47 years old, received $70,000 of group-term life insurance and elects to receive a permanent benefit under the policy. A pays $2 for each $1,000 of group-term life insurance through payroll deductions and the employer pays the remainder of the premium for the group-term life insurance. The employer also pays one-half of the premium specified in the policy for the permanent benefit. A pays the other one-half of the premium for the permanent benefit through payroll deductions. The policy specifies that the annual premium paid for the permanent benefit is $300. However, the amount of premium allocated to the permanent benefit by the formula in paragraph (d)(2) of this section is $350. A is a calendar year taxpayer; the policy year begins on January 1. In 1980, $200 is includible in A's income because of insurance provided by the employer. This amount is computed as follows:

(1) Cost of permanent benefits	$350
(2) Amounts considered paid by A for permanent benefits (½ × $300)	150
(3) Line (1) minus line (2)	200
(4) Cost of $70,000 of group-term life insurance under Table I of § 1.79-3	336
(5) Cost of $50,000 of group-term insurance under Table I of § 1.79-3	240
(6) Cost of group-term life insurance in excess of $50,000 (line (4) minus line (5))	96
(7) Amount considered paid by A for group-term life insurance (70 × $2)	140
(8) Line (6) minus line (7) (but not less than 0)	0
(9) Amount includible in income (line (3) plus line (8))	200

(e) *What is the effect of state law limits?* Section 79 does not apply to life insurance in excess of the limits under applicable state law on the amount of life insurance that can be provided to an employee under a single contract of group-term life insurance.

(f) *Cross references.* (1) See section 79(b) and § 1.79-2 for rules relating to group-term life insurance provided to certain retired individuals.

(2) See section 61(a) and the regulations thereunder for rules relating to life insurance not meeting the requirements of section 79, this section, or § 1.79-2, such as insurance provided on the life of a non-employee (for example, an employee's spouse), insurance not provided as compensation for personal services performed as an employee, insurance not provided under a policy carried directly or indirectly by the employer, or permanent benefits.

(3) See sections 106 and § 1.106-1 for rules relating to certain insurance that does not provide general death benefits, such as travel insurance or accident and health insurance (including amounts payable under a double indemnity clause or rider).

(g) *Effective date.* Sections 1.79-0 through 1.79-3 apply to insurance provided in employee taxable years beginning on or after January 1, 1977, with the following exceptions:

(1) A different effective date applies if—

(i) The insurance is provided under a plan of group insurance as defined in 26 CFR 1.79-1(b)(1)(iii) (revised as of April 1, 1979);

(ii) The plan of group-term life insurance was in effect on November 4, 1976; and

(iii) On November 4, 1976, the insurer was providing, or had entered into a binding contract to provide, insurance under the plan of group-term life insurance.

In that case, §§ 1.79-0 through 1.79-3 do not apply to insurance provided in

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employee taxable years beginning before January 1, 1978, that could have been provided under the terms of the plan of group-term life insurance as in effect on November 4, 1976.

(2) A special effective date applies to paragraph (b)(1)(iii) and (iv) of this section if—

(i) The conditions of paragraph (g)(1)(i), (ii), and (iii) of this section are met; and

(ii) The insurance did not satisfy the requirement of paragraph (b)(1)(iii) or (iv) of this section on November 4, 1976.

In that case, paragraph (b)(1)(iii) and (iv) of this section do not apply to insurance provided in employee taxable years beginning before January 1, 1983, that could have been provided under the terms of the plan of group-term life insurance as in effect on November 4, 1976.

(3) The third, fourth, and fifth sentences of the definition of "group of employees" in § 1.79-0 do not apply in taxable years beginning before January 1, 1979.

See 26 CFR 1.79-1 through 1.79-3 (revised as of April 1, 1979) for rules applicable to insurance provided in taxable years beginning before January 1, 1977 (January 1, 1978, if the insurance is described in paragraph (g)(1) of this section).

[T.D. 7623, 44 FR 28797, May 17, 1979]

§ 1.79-2 Exceptions to the rule of inclusion.

(a) *In general.* (1) Section 79(b) provides exceptions for the cost of group-term life insurance provided under certain policies otherwise described in section 79(a). The policy or policies of group-term life insurance which are described in section 79(a) but which qualify for one of the exceptions set forth in section 79(b) are described in paragraphs (b) through (d) of this section. Paragraph (b) of this section discusses the exception provided in section 79(b) (1); paragraph (c) of this section discusses the exception provided in section 79(b)(2); and paragraph (d) of this section discusses the exception provided in section 79(b)(3).

(2) (i) If a policy of group-term life insurance qualifies for an exception provided by section 79(b), then the amount equal to the cost of such insurance is excluded from the application of the provisions of section 79(a).

(ii) If a policy, or portion of a policy of group-term life insurance qualifies for an exception provided by section 79(b), the amount (if any) paid by the employee toward the purchase of such insurance is not to be taken into account as an amount referred to in section 79 (a)(2). In the case of a policy or policies of group-term life insurance which qualify for an exception provided by section 79(b) (1) or (3), the amount paid by the employee which is not to be taken into account as an amount referred to in section 79(a) (2) is the amount paid by the employee for the particular policy or policies of group-term life insurance which qualify for an exception provided under such section. If the exception provided in section 79(b)(2) is applicable only to a portion of the group-term life insurance on the employee's life, the amount considered to be paid by the employee toward the purchase of such portion is the amount equal to the excess of the cost of such portion of the insurance over the amount otherwise includible in the employee's gross income with respect to the group-term life insurance on his life carried directly or indirectly by such employer.

(iii) The rules of this subparagraph may be illustrated by the following example:

Example. A is an employee of X Corporation and is also an employee of Y Corporation, a subsidiary of X Corporation. A is provided, under a separate plan arranged by each of his employers, group-term life insurance on his life. During his taxable year, under the group-term life insurance plan of X Corporation, A is provided $60,000 of group-term life insurance on his life, and A pays $360.00 toward the purchase of such insurance. Under the group-term life insurance plan of Y Corporation, A is provided $65,000 of group-term life insurance on his life, but does not pay any part of the cost of such insurance. At the beginning of his taxable year, A terminates his employment with the X Corporation after he has reached the retirement age with respect to such employer, and the policy carried by the X Corporation qualifies for the exception provided by section 79(b)(1). For that taxable year, the cost of the group-term life insurance on A's life which is provided

under the plan of X Corporation is not taken into account in determining the amount includible in A's gross income under section 79(a), and A may not take into account as an amount described in section 79(a)(2) the $360.00 he pays toward the purchase of such insurance.

(b) *Retired and disabled employees*—(1) *In general.* Section 79(b)(1) provides an exception for the cost of group-term life insurance on the life of an individual which is provided under a policy or policies otherwise described in section 79(a) if the individual has terminated his employment (as defined in subparagraph (2) of this paragraph) with such employer and either has reached the retirement age with respect to such employer (as defined in subparagraph (3) of this paragraph), or has become disabled (as defined in subparagraph (4)(i) of this paragraph). If an individual who has terminated his employment attains retirement age or has become disabled during his taxable year, or if an employee who has attained retirement age or has become disabled terminates his employment during the taxable year, the exception provided by section 79(b)(1) applies only to the portion of the cost of group-term life insurance which is provided subsequent to the happening of the last event which qualifies the policy of insurance on the employee's life for the exception provided in such section.

(2) *Termination of employment.* For purposes of section 79(b)(1), an individual has terminated his employment with an employer providing such individual group-term life insurance when such individual no longer renders services to that employer as an employee of such employer.

(3) *Retirement age.* For purposes of section 79(b)(1) and this section, the meaning of the term "retirement age" is determined in accordance with the following rules—

(i) (*a*) If the employee is covered under a written pension or annuity plan of the employer providing such individual group-term life insurance on his life (whether or not such plan is qualified under section 401(a) or 403(a)), then his retirement age shall be considered to be the earlier of—

(*1*) The earliest age indicated by such plan at which an active employee has the right (or an inactive individual would have the right had he continued in employment) to retire without disability and without the consent of his employer and receive immediate retirement benefits computed at either the full rate or a rate proportionate to completed service as set forth in the normal retirement formula of the plan, i.e., without actuarial or similar reduction because of retirement before some later specified age, or

(*2*) The age at which it has been the practice of the employer to terminate, due to age, the services of the class of employees to which he last belonged.

(*b*) For purposes of (*a*) of this subdivision, if an employee is covered under more than one pension or annuity plan of the employer, his retirement age shall be determined with regard to that plan which covers that class of employees of the employer to which the employee last belonged. If the class of employees to which the employee last belonged is covered under more than one pension or annuity plan, then the employee's retirement age shall be determined with regard to that plan which covers the greatest number of the employer's employees.

(ii) In the absence of a written employee's pension or annuity plan described in subdivision (i) of this subparagraph, retirement age is the age, if any, at which it has been the practice of the employer to terminate, due to age, the services of the class of employees to which the particular employee last belonged, provided such age is reasonable in view of all the pertinent facts and circumstances.

(iii) If neither subdivision (i) or (ii) of this subparagraph applies, the retirement age is considered to be age 65.

(4) *Disabled.* (i) For taxable years beginning after December 31, 1966, an individual is considered disabled for purposes of section 79(b)(1) and subparagraph (1) of this paragraph if he is disabled within the meaning of section 72(m)(7) and paragraph (f) of § 1.72-17. For taxable years beginning before January 1, 1967, an individual is considered disabled for purposes of section 79(b)(1) and subparagraph (1) of this paragraph if he is disabled

within the meaning of section 213(g)(3), relating to the meaning of disabled, but the determination of the individual's status shall be made without regard to the provisions of section 213(g)(4), relating to the determination of status.

(ii) (*a*) In any taxable year in which an individual seeks to apply the exception set forth in section 79(b)(1) by reason of his being disabled within the meaning of subdivision (i) of this subparagraph, and in which the aggregate amount of insurance on the individual's life subject to the rule of inclusion set forth in section 79(a), but determined without regard to the amount of any insurance subject to any exception set forth in section 79(b), is greater than $50,000 of such insurance, the substantiation required by (*b*) or (*c*) of this subdivision must be submitted with the individual's tax return.

(*b*) For the first taxable year for which the individual seeks to apply the exception set forth in section 79(b)(1) by reason of his being disabled within the meaning of subdivision (i) of this subparagraph, there must be submitted with his income tax return a doctor's statement as to his impairment. There must also be submitted with the return a statement by the individual with respect to the effect of the impairment upon his substantial gainful activity, and the date such impairment occurred. For subsequent taxable years, the taxpayer may, in lieu of such statements, submit a statement declaring the continued existence (without substantial diminution) of the impairment and its continued effect upon his substantial gainful activity.

(*c*) In lieu of the substantiation required to be submitted by (*b*) of this subdivision for the taxable year, the individual may submit a signed statement issued to him by the insurer to the effect that the individual is disabled within the meaning of subdivision (i) of this paragraph. Such statement must set forth the basis for the insurer's determination that the individual was so disabled, and, for the first taxable year in which the individual is so disabled, the date such disability occurred.

(c) *Employer or charity a beneficiary*—(1) *General rule.* Section 79(b)(2) provides an exception with respect to the amounts referred to in section 79(a) for the cost of any portion of the group-term life insurance on the life of an employee provided during part or all of the taxable year of the employee under which the employer is directly or indirectly the beneficiary, or under which a person described in section 170(c) (relating to definition of charitable contributions) is the sole beneficiary, for the entire period during such taxable year for which the employee receives such insurance.

(2) *Employer is a beneficiary.* For purposes of section 79(b)(2) and subparagraph (1) of this paragraph, the determination of whether the employer is directly or indirectly the beneficiary under a policy or policies of group-term life insurance depends upon the facts and circumstances of the particular case. Such determination is not made solely with regard to whether the employer possesses all the incidents of ownership in the policy. Thus, for example, if the employer is the nominal beneficiary under a policy of group-term life insurance on the life of his employee but there is an arrangement whereby the employer is required to pay over all (or a portion) of the proceeds of such policy to the employee's estate or his beneficiary, the employer is not considered a beneficiary under such policy (or such portion of the policy).

(3) *Charity a beneficiary.* (i) For purposes of section 79(b)(2) and subparagraph (1) of this paragraph, a person described in section 170(c) is a beneficiary under a policy providing group-term life insurance if such person is designated the beneficiary under the policy by any assignment or designation of beneficiary under the policy which, under the law of the jurisdiction which is applicable to the policy, has the effect of making such person the beneficiary under such policy (whether or not such designation is revocable during the taxable year). Such a designation may be made by the employee with respect to any portion of the group-term life insurance on his life. However, no deduction is allowed under section 170, relating to charita-

ble, etc., contributions and gifts, with respect to any such assignment or designation.

(ii) A person described in section 170(c) must be designated the sole beneficiary under the policy or portion of the policy. Such requirement is satisfied if the person described in section 170(c) is the beneficiary under such policy or portion of the policy, and there is no contingent or similar beneficiary under such policy or such portion other than a person described in section 170(c). A general "preference beneficiary clause" in a policy governing payment where there is no designated beneficiary in existence at the death of the employee will not of itself be considered to create a contingent or similar beneficiary. A person described in section 170(c) may be designated the beneficiary under a portion of the policy if such person is designated the sole beneficiary under a beneficiary designation which is expressed, for example, as a fraction of the amount of insurance on the insured's life.

(iii) If a person described in section 170(c) is designated, before May 1, 1964, the beneficiary under the policy (or portion thereof) and such person remains the beneficiary for the period beginning May 1, 1964, and ending with the close of the first taxable year of the employee ending after April 30, 1964, such person shall be treated as the beneficiary under the policy (or the portion thereof) for the period beginning January 1, 1964, and ending April 30, 1964.

(d) *Insurance contracts purchased under qualified employee plans.* (1) Section 79(b)(3) provides an exception with respect to the cost of any group-term life insurance which is provided under a life insurance contract purchased as a part of a plan described in section 403(a), or purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) if the proceeds of such contract are payable directly or indirectly to a participant in such trust or to a beneficiary of such participant. The provisions of section 72(m)(3) and § 1.72-16 apply to the cost of such group-term life insurance, and, therefore, no part of such cost is excluded from the gross income of the employee by reason of the provisions of section 79.

(2) Whether the life insurance protection on an employee's life is provided under a qualified employee plan referred to in subparagraph (1) of this paragraph depends upon the provisions of such plan. In determining whether a pension, profit-sharing, stock bonus, or annuity plan satisfies the requirements for qualification set forth in sections 401(a) or 403(a), only group-term life insurance which is provided under such plan is taken into account.

[T.D. 6888, 31 FR 9201, July 6, 1966, as amended by T.D. 6919, 32 FR 7390, May 18, 1967; T.D. 6985, 33 FR 19812, Dec. 27, 1968; T.D. 7623, 44 FR 28800, May 17, 1979]

§ 1.79-3 Determination of amount equal to cost of group-term life insurance.

(a) *In general.* This section prescribes the rules for determining the amount equal to the cost of group-term life insurance on an employee's life which is to be included in his gross income pursuant to the rule of inclusion set forth in section 79(a). Such amount is determined by—

(1) Computing the cost of the portion of the group-term life insurance on the employee's life to be taken into account (determined in accordance with the rules set forth in paragraph (b) of this section) for each "period of coverage" (as defined in paragraph (c) of this section) and aggregating the costs so determined, then

(2) Reducing the amount determined under subparagraph (1) of this paragraph by the amount determined in accordance with the rules set forth in paragraph (e) of this section, relating to the amount paid by the employee toward the purchase of group-term life insurance.

(b) *Determination of the portion of the group-term life insurance on the employee's life to be taken into account.* (1) For each "period of coverage" (as defined in paragraph (c) of this section), the portion of the group-term life insurance to be taken into account in computing the amount includible in an employee's gross income for purposes of paragraph (a)(1) of this section is the sum of the proceeds

payable upon the death of the employee under each policy, or portion of a policy, of group-term life insurance on such employee's life to which the rule of inclusion set forth in section 79(a) applies, less $50,000 of such insurance. Thus, the amount of any proceeds payable under a policy, or portion of a policy, which qualifies for one of the exceptions to the rule of inclusion provided by section 79(b) is not taken into account. For the regulations relating to such exceptions to the rule of inclusion, see § 1.79-2.

(2) For purposes of making the computation required by subparagraph (1) of this paragraph in any case in which the amount payable under the policy, or portion thereof, varies during the period of coverage, the amount payable under such policy during such period is considered to be the average of the amount payable under such policy at the beginning and the end of such period.

(3) (i) For purposes of making the computation required by subparagraph (1) of this paragraph in any case in which the amount payable under the policy is not payable as a specific amount upon the death of the employee in full discharge of the liability of the insurer, and such form of payment is not one of alternative methods of payment, the amount payable under such policy is the present value of the agreement by the insurer under the policy to make the payments to the beneficiary or beneficiaries entitled to such amounts upon the employee's death. For each period of coverage, such present value is to be determined as if the first and last day of such period is the date of death of the employee.

(ii) The present value of the agreement by the insurer under the policy to make payments shall be determined by the use of the mortality tables and interest rate employed by the insurer with respect to such a policy in calculating the amount held by the insurer (as defined in section 101(d)(2)), unless the Commissioner otherwise determines that a particular mortality table and interest rate, representative of the mortality table and interest rate used by commercial insurance companies with respect to such policies, shall be used to determine the present value of the policy for purposes of this subdivision.

(iii) For purposes of making the computation required by subdivision (i) of this subparagraph in any case in which it is necessary to determine the age of an employee's beneficiary and such beneficiary remains the same (under the policy, or the portion of the policy, with respect to which the determination of the present value of the agreement of the insurer to pay benefits is being made) for the entire period during the employee's taxable year for which such policy is in effect, the age of such beneficiary is such beneficiary's age at his nearest birthday on June 30th of the calendar year.

(iv) If the policy of group-term life insurance on the employee's life is such that the present value of the agreement by the insurer under the policy to pay benefits cannot be determined by the rules prescribed in this subparagraph, the taxpayer may submit with his return a computation of such present value, consistent with the actuarial and other assumptions set forth in this subparagraph, showing the appropriate factors applied in his case. Such computation shall be subject to the approval of the Commissioner upon examination of such return.

(c) *Period of coverage.* For purposes of this section, the phrase "period of coverage" means any one calendar month period, or part thereof, during the employee's taxable year during which the employee is provided group-term life insurance on his life to which the rule of inclusion set forth in section 79(a) applies. The phrase "part thereof" as used in the preceding sentence means any continuous period which is less than the one calendar month period referred to in the preceding sentence for which premiums are charged by the insurer.

(d) *The cost of the portion of the group-term life insurance on an employee's life.* (1) This paragraph sets forth the rules for determining the cost, for each period of coverage, of the portion of the group-term life insurance on the employee's life to be taken into account in computing the amount includible in the employee's

gross income for purposes of paragraph (a)(1) of this section. The portion of the group-term life insurance on the employee's life to be taken into account is determined in accordance with the provisions of paragraph (b) of this section. Table I, which is set forth in subparagraph (2) of this paragraph, determines the cost for each $1,000 of such portion of the group-term life insurance on the employee's life for each one-month period. The cost of the portion of the group-term life insurance on the employee's life for each period of coverage of one month is obtained by multiplying the number of thousand dollars of such insurance computed to the nearest tenth which is provided during such period by the appropriate amount set forth in Table I. In any case in which group-term life insurance is provided for a period of coverage of less than one month, the amount set forth in Table I is prorated over such period of coverage.

(2) The following table sets forth the cost of $1,000 of group-term life insurance for 1 month computed on the basis of 5-year age brackets. For purposes of Table I, the age of the employee is his attained age on the last day of his taxable year. However, if an employee has attained an age greater than age 64, he shall be treated as if he were in the 5-year age bracket 60 to 64.

TABLE I.—UNIFORM PREMIUMS FOR $1,000 OF GROUP-TERM LIFE INSURANCE PROTECTION

5-year age bracket	Cost per $1,000 of protection for 1-month period
Under 30	$0.08
30 to 34	.10
35 to 39	.14
40 to 44	.23
45 to 49	.40
50 to 54	.68
55 to 59	1.10
60 to 64	1.63

(3) The net premium cost of group-term life insurance as provided in Table I of subparagraph (2) of this paragraph applies only to the cost of group-term life insurance subject to the rule of inclusion set forth in section 79(a). Therefore, such net premium cost is not applicable to the determination of the cost of group-term life insurance provided under a policy which is not subject to such rule of inclusion.

(e) *Amount paid by the employee toward the purchase of group-term life insurance.* (1) Except as otherwise provided in subparagraph (2) of this paragraph, if an employee pays any amount toward the purchase of group-term life insurance provided for a taxable year which is subject to the rule of inclusion set forth in paragraph (a)(2) of § 1.79–1, the sum of all such amounts is the amount referred to in section 79(a)(2) and paragraph (a)(2) of this section. The rule of the preceding sentence applies even though the payments made by the employee are made with respect to a period of coverage during which no portion of the group-term life insurance on his life is taken into account under paragraph (b)(1) of this section.

(2) In determining the amount paid by the employee for purposes of section 79(a)(2) and paragraph (a)(2) of this section, there is not taken into account any amounts paid by the employee for group-term life insurance provided (or to be provided) for a different taxable year (other than amounts applicable to regular pay periods extending into the next taxable year). Thus, for example, if part of an employee's payment during a taxable year represents a prepayment for insurance to be provided after his retirement, such part does not reduce the amount includible in his gross income for the current taxable year. Furthermore, in determining such amount, there is not taken into account any amount paid by an employee toward the purchase of group-term life insurance which qualifies for one of the exceptions described in section 79(b). The amount paid by an employee toward the purchase of group-term life insurance which qualifies for one of the exceptions described in section 79(b) is determined under the rules of paragraph (a)(2) of § 1.79–2.

(3) If payments are made by the employer and his employees to provide group-term life insurance which is subject to the rule of inclusion set forth

in section 79(a) as well as to provide other benefits for the employees, and if the amount paid by the employee toward the purchase of such insurance cannot be determined by the provisions of the policy or plan under which such benefits are provided, then the determination of the portion of the cost of group-term life insurance (computed in accordance with the provisions of this section) which is attributable to the contributions of the employee shall be made in accordance with the provisions of this subparagraph. The amount paid by the employee toward the purchase of all the group-term life insurance on his life for his taxable year (or for the portion of his taxable year if such portion is the basis of the computation) under such group policy shall be an amount determined first by ascertaining the total amount paid by all employees who are covered for multiple benefits which is allocable toward the purchase of group-term life insurance on their lives for the year, and then by ascertaining the pro rata portion of such total amount attributable to the individual employee. The total amount paid by all employees who are covered for multiple benefits which is allocable toward the purchase of group-term life insurance on their lives with respect to such year shall be an amount which bears the same ratio to the total amount paid by all employees for multiple benefits with respect to such year as the aggregate premiums paid to the insurer for group-term life insurance on such employees' lives with respect to such year bears to the aggregate premiums paid to the insurer for such multiple benefits with respect to such year. The pro rata portion of such total amount attributable to the individual employee for the cost of group-term life insurance on his life shall be an amount which bears the same ratio to the total amount paid by all employees which is allocable toward the purchase of group-term insurance on their lives with respect to such year as the amount of group-term life insurance on the life of the employee at a specified time during the year, as determined by the employer, bears to the total amount of group-term life insurance on the lives of all employees insured for such multiple benefits at such time.

(f) *Effect of provision of other benefits*—(1) *In general.* This paragraph discusses the effect of the provision of certain benefits other than group-term life insurance on the life of the employee if the provision of such benefits is contingent upon the underwriting of group-term life insurance on the employee's life to which the rule of inclusion set forth in section 79(a) applies.

(2) *Dependent coverage.* An amount equal to the cost of group-term life insurance on the life of the spouse or other family member of the employee which is provided under a policy of group-term life insurance carried directly or indirectly by his employer is not subject to the provisions of section 79 since it is not on the life of the employee. See paragraph (d)(2)(ii)(*b*) of § 1.61-2 for rules regarding the tax treatment of such insurance.

(3) *Disability provisions.* Payments made for disability benefits provided under a group-term life insurance contract are considered to constitute payments made for accident and health insurance. Thus, employer contributions to provide such benefits are excluded from gross income by reason of the provisions of section 106.

(4) *Cost of other benefits.* If a benefit described in this paragraph is provided under a policy under which both the employer and his employees contribute, then, except as otherwise provided in this subparagraph, the employer and the employees will be treated as contributing toward the payment of such benefit at the same rate as they contribute toward the cost of group-term life insurance on the employees' lives. A separate allocation of employer and employee contributions for such benefits is permissible only if—

(i) Such separate allocation is set forth in the group policy and is applicable to all the employees covered under such policy;

(ii) Such separate allocation is followed in transactions between the insurer and the group-policyholder; and

(iii) The allocation set forth in the policy satisfies the requirements of the law of the jurisdiction which is applicable to the contract regarding any

minimum or maximum contribution rate by the employer or the employees.

[T.D. 6888, 31 FR 9203, July 6, 1966, as amended by T.D. 7623, 44 FR 28800, May 17, 1979]

§ 1.82-1 Payments for or reimbursements of expenses of moving from one residence to another residence attributable to employment or self-employment.

(a) *Reimbursements in gross income*—(1) *In general.* Any amount received or accrued, directly or indirectly, by an individual as a payment for or reimbursement of expenses of moving from one residence to another residence attributable to employment or self-employment is includible in gross income under section 82 as compensation for services in the taxable year received or accrued. For rules relating to the year a deduction may be allowed for expenses of moving from one residence to another residence, see section 217 and the regulations thereunder.

(2) *Amounts received or accrued as reimbursement or payment.* For purposes of this section, amounts are considered as being received or accrued by an individual as reimbursement or payment whether received in the form of money, property, or services. A cash basis taxpayer will include amounts in gross income under section 82 when they are received or treated as received by him. Thus, for example, if an employer moves an employee's household goods and personal effects from the employee's old resident to his new residence using the employer's facilities, the employee is considered as having received a payment in the amount of the fair market value of the services furnished at the time the services are furnished by the employer. If the employer pays a mover for moving the employee's household goods and personal effects, the employee is considered as having received the payment at the time the employer pays the mover, rather than at the time the mover moves the employee's household goods and personal effects. Where an employee receives a loan or advance from an employer to enable him to pay his moving expenses, the employee will not be deemed to have received a reimbursement of moving expenses until such time as he accounts to his employer if he is not required to repay such loan or advance and if he makes such accounting within a reasonable time. Such loan or advance will be deemed to be a reimbursement of moving expenses at the time of such accounting to the extent used by the employee for such moving expenses.

(3) *Direct or indirect payments or reimbursements.* For purposes of this section amounts are considered as being received or accrued whether received directly (paid or provided to an individual by an employer, a client, a customer, or similar person) or indirectly (paid to a third party on behalf of an individual by an employer, a client, a customer, or similar person). Thus, if an employer pays a mover for the expenses of moving an employee's household goods and personal effects from one residence to another residence, the employee has indirectly received a payment which is includible in his gross income under section 82.

(4) *Expenses of moving from one residence to another residence.* An expense of moving from one residence to another residence is any expenditure, cost, loss, or similar item paid or incurred in connection with a move from one residence to another residence. Moving expenses include (but are not limited to) any expenditure, cost, loss, or similar item directly or indirectly resulting from the acquisition, sale, or exchange of property, the transportation of goods or property, or travel (by the taxpayer or any other person) in connection with a change in residence. Such expenses include items described in section 217(b) (relating to the definition of moving expenses), irrespective of the dollar limitations contained in section 217(b)(3) and the conditions contained in section 217(c), as well as items not described in section 217 (b), such as a loss sustained on the sale or exchange of personal property, storage charges, taxes, or expenses of refitting rugs or draperies.

(5) *Attributable to employment or self-employment.* Any amount received or accrued from an employer, a client, a customer, or similar person in connection with the performance of serv-

ices for such employer, client, customer, or similar person, is attributable to employment or self-employment. Thus, for example, if an employer reimburses an employee for a loss incurred on the sale of the employee's house, reimbursement is attributable to the performance of services if made because of the employer-employee relationship. Similarly, if an employer in order to prevent an employee's sustaining a loss on a sale of a house acquires the property from the employee at a price in excess of fair market value, the employee is considered to have received a payment attributable to employment to the extent that such payment exceeds the fair market value of the property.

(b) *Effective date*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, paragraph (a) of this section is applicable only to amounts received or accrued in taxable years beginning after December 31, 1969.

(2) *Election with respect to payments or reimbursements for expenses paid or incurred before January 1, 1971.* Paragraph (a) of this section does not apply with respect to moving expenses paid or incurred before January 1, 1971, in connection with the commencement of work by an employee at a new principal place of work where such employee had been notified by his employer on or before December 19, 1969, of such move and the employee makes an election under paragraph (h) of § 1.217-2.

[T.D. 7195, 37 FR 13533, July 11, 1972, as amended by T.D. 7578, 43 FR 59355, Dec. 20, 1978]

§ 1.83-1 Property transferred in connection with the performance of services.

(a) *Inclusion in gross income*—(1) *General rule.* Section 83 provides rules for the taxation of property transferred to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services by such employee or independent contractor. In general, such property is not taxable under section 83(a) until it has been transferred (as defined in § 1.83-3(a)) to such person and become substantially vested (as defined in § 1.83-3(b)) in such person. In that case, the excess of—

(i) The fair market value of such property (determined without regard to any lapse restriction, as defined in § 1.83-3(i)) at the time that the property becomes substantially vested, over

(ii) The amount (if any) paid for such property,

shall be included as compensation in the gross income of such employee or independent contractor for the taxable year in which the property becomes substantially vested. Until such property becomes substantially vested, the transferor shall be regarded as the owner of such property, and any income from such property received by the employee or independent contractor (or beneficiary thereof) or the right to the use of such property by the employee or independent contractor constitutes additional compensation and shall be included in the gross income of such employee or independent contractor for the taxable year in which such income is received or such use is made available. This paragraph applies to a transfer of property in connection with the performance of services even though the transferor is not the person for whom such services are performed.

(2) *Life insurance.* The cost of life insurance protection under a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection is taxable generally under section 61 and the regulations thereunder during the period such contract remains substantially nonvested (as defined in § 1.83-3(b)). The cost of such life insurance protection is the reasonable net premium cost, as determined by the Commissioner, of the current life insurance protection (as defined in § 1.72-16(b)(3)) provided by such contract.

(3) *Cross references.* For rules concerning the treatment of employers and other transferors of property in connection with the performance of services, see section 83(h) and § 1.83-6. For rules concerning the taxation of beneficiaries of an employees' trust that is not exempt under section

501(a), see section 402(b) and the regulations thereunder.

(b) *Subsequent sale, forfeiture, or other disposition of nonvested property.* (1) If substantially nonvested property (that has been transferred in connection with the performance of services) is subsequently sold or otherwise disposed of to a third party in an arm's length transaction while still substantially nonvested, the person who performed such services shall realize compensation in an amount equal to the excess of—

(i) The amount realized on such sale or other disposition, over

(ii) The amount (if any) paid for such property.

Such amount of compensation is includible in his gross income in accordance with his method of accounting. Two preceding sentences also apply when the person disposing of the property has received it in a non-arm's length transaction described in paragraph (c) of this section. In addition, section 83(a) and paragraph (a) of this section shall thereafter cease to apply with respect to such property.

(2) If substantially nonvested property that has been transferred in connection with the performance of services to the person performing such services is forfeited while still substantially nonvested and held by such person, the difference between the amount paid (if any) and the amount received upon forfeiture (if any) shall be treated as an ordinary gain or loss. This paragraph (b)(2) does not apply to property to which § 1.83-2(a) applies.

(3) This paragraph (b) shall not apply to, and no gain shall be recognized on, any sale, forfeiture, or other disposition described in this paragraph to the extent that any property received in exchange therefor is substantially nonvested. Instead, section 83 and this section shall apply with respect to such property received (as if it were substituted for the property disposed of).

(c) *Dispositions of nonvested property not at arm's length.* If substantially nonvested property (that has been transferred in connection with the performance of services) is disposed of in a transaction which is not at arm's length and the property remains substantially nonvested, the person who performed such services realizes compensation equal in amount to the sum of any money and the fair market value of any substantially vested property received in such disposition. Such amount of compensation is includible in his gross income in accordance with his method of accounting. However, such amount of compensation shall not exceed the fair market value of the property disposed of at the time of disposition (determined without regard to any lapse restriction), reduced by the amount paid for such property. In addition, section 83 and these regulations shall continue to apply with respect to such property, except that any amount previously includible in gross income under this paragraph (c) shall thereafter be treated as an amount paid for such property. For example, if in 1971 an employee pays $50 for a share of stock which has a fair market value of $100 and is substantially monvested at that time and later in 1971 (at a time when the property still has a fair market value of $100 and is still substantially nonvested) the employee disposes of, in a transaction not at arm's length, the share of stock to his wife for $10, the employee realizes compensation of $10 in 1971. If in 1972, when the share of stock has a fair market value of $120, it becomes substantially vested, the employee realizes additional compensation in 1972 in the amount of $60 (the $120 fair market value of the stock less both the $50 price paid for the stock and the $10 taxed as compensation in 1971). For purposes of this paragraph, if substantially nonvested property has been transferred to a person other than the person who performed the services, and the transferee dies holding the property while the property is still substantially nonvested and while the person who performed the services is alive, the transfer which results by reason of the death of such transferee is a transfer not at arm's length.

(d) *Certain transfers upon death.* If substantially nonvested property has been transferred in connection with the performance of services and the person who performed such services

dies while the property is still substantially nonvested, any income realized on or after such death with respect to such property under this section is income in respect of a decedent to which the rules of section 691 apply. In such a case the income in respect of such property shall be taxable under section 691 (except to the extent not includible under section 101(b)) to the estate or beneficiary of the person who performed the services, in accordance with section 83 and the regulations thereunder. However, if an item of income is realized upon such death before July 21, 1978, because the property became substantially vested upon death, the person responsible for filing decedent's income tax return for decedent's last taxable year may elect to treat such item as includible in gross income for decedent's last taxable year by including such item in gross income on the return or amended return filed for decedent's last taxable year.

(e) *Forfeiture after substantial vesting.* If a person is taxable under section 83(a) when the property transferred becomes substantially vested and thereafter the person's beneficial interest in such property is nevertheless forfeited pursuant to a lapse restriction, any loss incurred by such person (but not by a beneficiary of such person) upon such forfeiture shall be an ordinary loss to the extent the basis in such property has been increased as a result of the recognition of income by such person under section 83(a) with respect to such property.

(f) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). On November 1, 1978, X corporation sells to E, an employee, 100 shares of X corporation stock at $10 per share. At the time of such sale the fair market value of the X corporation stock is $100 per share. Under the terms of the sale each share of stock is subject to a substantial risk of forfeiture which will not lapse until November 1, 1988. Evidence of this restriction is stamped on the face of E's stock certificates, which are therefore nontransferable (within the meaning of § 1.83-3(d)). Since in 1978 E's stock is substantially nonvested, E does not include any of such amount in his gross income as compensation in 1978. On November 1, 1988, the fair market value of the X corporation stock is $250 per share. Since the X corporation stock becomes substantially vested in 1988, E must include $24,000 (100 shares of X corporation stock × $250 fair market value per share less $10 price paid by E for each share) as compensation for 1988. Dividends paid by X to E on E's stock after it was transferred to E on November 1, 1973, are taxable to E as additional compensation during the period E's stock is substantially nonvested and are deductible as such by X.

Example (2). Assume the facts are the same as in example (1), except that on November 1, 1985, each share of stock of X corporation in E's hands could as a matter of law be transferred to a bona fide purchaser who would not be required to forfeit the stock if the risk of forfeiture materialized. In the event, however, that the risk materializes, E would be liable in damages to X. On November 1, 1985, the fair market value of the X corporation stock is $230 per share. Since E's stock is transferable within the meaning of § 1.83-3(d) in 1985, the stock is substantially vested and E must include $22,000 (100 shares of X corporation stock × $230 fair market value per share less $10 price paid by E for each share) as compensation for 1985.

Example (3). Assume the facts are the same as in example (1) except that, in 1984 E sells his 100 shares of X corporation stock in an arm's length sale to I, an investment company, for $120 per share. At the time of this sale each share of X corporation's stock has a fair market value of $200. Under paragraph (b) of this section, E must include $11,000 (100 shares of X corporation stock × $120 amount realized per share less $10 price paid by E per share) as compensation for 1984 notwithstanding that the stock remains nontransferable and is still subject to a substantial risk of forfeiture at the time of such sale. Under § 1.83-4(b)(2), I's basis in the X corporation stock is $120 per share.

[T.D. 7554, 43 FR 31913, July 24, 1978]

§ 1.83-2 Election to include in gross income in year of transfer.

(a) *In general.* If property is transferred (within the meaning of § 1.83-3(a)) in connection with the performance of services, the person performing such services may elect to include in gross income under section 83(b) the excess (if any) of the fair market value of the property at the time of transfer (determined without regard to any lapse restriction, as defined in § 1.83-3(i)) over the amount (if any) paid for such property, as compensation for services. The fact that the transferee has paid full value for the

property transferred, realizing no bargain element in the transaction, does not preclude the use of the election as provided for in this section. If this election is made, the substantial vesting rules of section 83(a) and the regulations thereunder do not apply with respect to such property, and except as otherwise provided in section 83(d)(2) and the regulations thereunder (relating to the cancellation of a nonlapse restriction), any subsequent appreciation in the value of the property is not taxable as compensation to the person who performed the services. Thus, property with respect to which this election is made shall be includible in gross income as of the time of transfer, even though such property is substantially nonvested (as defined in § 1.83-3(b)) at the time of transfer, and no compensation will be includible in gross income when such property becomes substantially vested (as defined in § 1.83-3(b)). In computing the gain or loss from the subsequent sale or exchange of such property, its basis shall be the amount paid for the property increased by the amount included in gross income under section 83(b). If property for which a section 83(b) election is in effect is forfeited while substantially nonvested, such forfeiture shall be treated as a sale or exchange upon which there is realized a loss equal to the excess (if any) of—

(1) The amount paid (if any) for such property, over,

(2) The amount realized (if any) upon such forfeiture.

If such property is a capital asset in the hands of the taxpayer, such loss shall be a capital loss. A sale or other disposition of the property that is in substance a forfeiture, or is made in contemplation of a forfeiture, shall be treated as a forfeiture under the two immediately preceding sentences.

(b) *Time for making election.* Except as provided in the following sentence, the election referred to in paragraph (a) of this section shall be filed not later than 30 days after the date the property was transferred (or, if later, January 29, 1970) and may be filed prior to the date of transfer. Any statement filed before February 15, 1970, which was amended not later than February 16, 1970, in order to make it conform to the requirements of paragraph (e) of this section, shall be deemed a proper election under section 83(b).

(c) *Manner of making election.* The election referred to in paragraph (a) of this section is made by filing one copy of a written statement with the internal revenue office with whom the person who performed the services files his return. In addition, one copy of such statement shall be submitted with this income tax return for the taxable year in which such property was transferred.

(d) *Additional copies.* The person who performed the services shall also submit a copy of the statement referred to in paragraph (c) of this section to the person for whom the services are performed. In addition, if the person who performs the services and the transferee of such property are not the same person, the person who performs the services shall submit a copy of such statement to the transferee of the property.

(e) *Content of statement.* The statement shall be signed by the person making the election and shall indicate that it is being made under section 83(b) of the Code, and shall contain the following information:

(1) The name, address and taxpayer identification number of the taxpayer;

(2) A description of each property with respect to which the election is being made;

(3) The date or dates on which the property is tansferred and the taxable year (for example, "calendar year 1970" or "fiscal year ending May 31, 1970") for which such election was made;

(4) The nature of the restriction or restrictions to which the property is subject;

(5) The fair market value at the time of transfer (determined without regard to any lapse restriction, as defined in § 1.83-3(i)) of each property with respect to which the election is being made;

(6) The amount (if any) paid for such property; and

(7) With respect to elections made after July 21, 1978, a statement to the effect that copies have been furnished

to other persons as provided in paragraph (d) of this section.

(f) *Revocability of election.* An election under section 83(b) may not be revoked except with the consent of the Commissioner. Consent will be granted only in the case where the transferee is under a mistake of fact as to the underlying transaction and must be requested within 60 days of the date on which the mistake of fact first became known to the person who made the election. In any event, a mistake as to the value, or decline in the value, of the property with respect to which an election under section 83(b) has been made or a failure to perform an act contemplated at the time of transfer of such property does not constitute a mistake of fact.

[T.D. 7554, 43 FR 31915, July 24, 1978]

§ 1.83-3 Meaning and use of certain terms.

(a) *Transfer*—(1) *In general.* For purposes of section 83 and the regulations thereunder, a transfer of property occurs when a person acquires a beneficial ownership interest in such property (disregarding any lapse restriction, as defined in § 1.83-3(i)).

(2) *Option.* The grant of an option to purchase certain property does not constitute a transfer of such property. However, see § 1.83-7 for the extent to which the grant of the option itself is subject to section 83. In addition, if the amount paid for the transfer of property is an indebtedness secured by the transferred property, on which there is no personal liability to pay all or a substantial part of such indebtedness, such transaction may be in substance the same as the grant of an option. The determination of the substance of the transaction shall be based upon all the facts and circumstances. The factors to be taken into account include the type of property involved, the extent to which the risk that the property will decline in value has been transferred, and the likelihood that the purchase price will, in fact, be paid. See also § 1.83-4(c) for the treatment of forgiveness of indebtedness that has constituted an amount paid.

(3) *Requirement that property be returned.* Similarly, no transfer may have occurred where property is transferred under conditions that require its return upon the happening of an event that is certain to occur, such as the termination of employment. In such a case, whether there is, in fact, a transfer depends upon all the facts and circumstances. Factors which indicate that no transfer has occurred are described in paragraph (a) (4), (5), and (6) of this section.

(4) *Similarity to option.* An indication that no transfer has occurred is the extent to which the conditions relating to a transfer are similar to an option.

(5) *Relationship to fair market value.* An indication that no transfer has occurred is the extent to which the consideration to be paid the transferee upon surrendering the property does not approach the fair market value of the property at the time of surrender. For purposes of paragraph (a) (5) and (6) of this section, fair market value includes fair market value determined under the rules of § 1.83-5(a)(1), relating to the valuation of property subject to nonlapse restrictions. Therefore, the existence of a nonlapse restriction referred to in § 1.83-5(a)(1) is not a factor indicating no transfer has occurred.

(6) *Risk of loss.* An indication that no transfer has occurred is the extent to which the transferee does not incur the risk of a beneficial owner that the value of the property at the time of transfer will decline substantially. Therefore, for purposes of this (6), risk of decline in property value is not limited to the risk that any amount paid for the property may be lost.

(7) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). On January 3, 1971, X corporation sells for $500 to S, a salesman of X, 10 shares of stock in X corporation with a fair market value of $1,000. The stock is nontransferable and subject to return to the corporation (for $500) if S's sales do not reach a certain level by December 31, 1971. Disregarding the restriction concerning S's sales (since the restrictions is a lapse restriction), S's interest in the stock is that of a beneficial owner and therefore a transfer occurs on January 3, 1971.

Example (2). On November 17, 1972, W sells to E 100 shares of stock in W corporation with a fair market value of $10,000 in

exchange for a $10,000 note without personal liability. The note requires E to make yearly payments of $2,000 commencing in 1973. E collects the dividends, votes the stock and pays the interest on the note. However, he makes no payments toward the face amount of the note. Because E has no personal liability on the note, and since E is making no payments towards the face amount of the note, the likelihood of E paying the full purchase price is in substantial doubt. As a result E has not incurred the risks of a beneficial owner that the value of the stock will decline. Therefore, no transfer of the stock has occurred on November 17, 1972, but an option to purchase the stock has been granted to E.

Example (3). On January 3, 1971, X corporation purports to transfer to E, an employee, 100 shares of stock in X corporation. The X stock is subject to the sole restriction that E must sell such stock to X on termination of employment for any reason for an amount which is equal to the excess (if any) of the book value of the X stock at termination of employment over book value on January 3, 1971. The stock is not transferable by E and the restrictions on transfer are stamped on the certificate. Under these facts and circumstances, there is no transfer of the X stock within the meeting of section 83.

Example (4). Assume the same facts as in example (3) except that E paid $3,000 for the stock and that the restriction required E upon termination of employment to sell the stock to M for the total amount of dividends that have been declared on the stock since September 2, 1971, or $3,000 whichever is higher. Again, under the facts and circumstances, no transfer of the X stock has occurred.

Example (5). On July 4, 1971, X corporation purports to transfer to G, an employee, 100 shares of X stock. The stock is subject to the sole restriction that upon termination of employment G must sell the stock to X for the greater of its fair market value at such time or $100, the amount G paid for the stock. On July 4, 1971 the X stock has a fair market value of $100. Therefore, G does not incur the risk of a beneficial owner that the value of the stock at the time of transfer ($100) will decline substantially. Under these facts and circumstances, no transfer has occurred.

(b) *Substantially vested and substantially nonvested property.* For purposes of section 83 and the regulations thereunder, property is substantially nonvested when it is subject to a substantial risk of forfeiture, within the meaning of paragraph (c) of this section, and is nontransferable, within the meaning of paragraph (d) of this section. Property is substantially vested for such purposes when it is either transferable or not subject to a substantial risk of forfeiture.

(c) *Substantial risk of forfeiture*—(1) *In general.* For purposes of section 83 and the regulations thereunder, whether a risk of forfeiture is substantial or not depends upon the facts and circumstances. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.

Property is not transferred subject to a substantial risk of forfeiture to the extent that the employer is required to pay the fair market value of a portion of such property to the employee upon the return of such property. The risk that the value of property will decline during a certain period of time does not constitute a substantial risk of forfeiture. A nonlapse restriction, standing by itself, will not result in a substantial risk of forfeiture.

(2) *Illustrations of substantial risks of forfeiture.* The regularity of the performance of services and the time spent in performing such services tend to indicate whether services required by a condition are substantial. The fact that the person performing services has the right to decline to perform such services without forfeiture may tend to establish that services are insubstantial. Where stock is transferred to an underwriter prior to a public offering and the full enjoyment of such stock is expressly or impliedly conditioned upon the successful completion of the underwriting, the stock is subject to a substantial risk of forfeiture. Where an employee receives property from an employer subject to a requirement that it be returned if the total earnings of the employer do not increase, such property is subject to a substantial risk of forfeiture. On the other hand, requirements that the property be returned to the employer if the employee is discharged for cause

or for committing a crime will not be considered to result in a substantial risk of forfeiture. An enforceable requirement that the property be returned to the employer if the employee accepts a job with a competing firm will not ordinarily be considered to result in a substantial risk of forfeiture unless the particular facts and circumstances indicate to the contrary. Factors which may be taken into account in determining whether a convenant not to compete constitutes a substantial risk of forfeiture are the age of the employee, the availability of alternative employment opportunities, the likelihood of the employee's obtaining such other employment, the degree of skill possessed by the employee, the employee's health, and the practice (if any) of the employer to enforce such covenants. Similarly, rights in property transferred to a retiring employee subject to the sole requirement that it be returned unless he renders consulting services upon the request of his former employer will not be considered subject to a substantial risk of forfeiture unless he is in fact expected to perform substantial services.

(3) *Enforcement of forfeiture condition.* In determining whether the possibility of forfeiture is substantial in the case of rights in property transferred to an employee of a corporation who owns a significant amount of the total combined voting power or value of all classes of stock of the employer corporation or of its parent corporation, there will be taken into account (i) the employee's relationship to other stockholders and the extent of their control, potential control and possible loss of control of the corporation, (ii) the position of the employee in the corporation and the extent to which he is subordinate to other employees, (iii) the employee's relationship to the officers and directors of the corporation, (iv) the person or persons who must approve the employee's discharge, and (v) past actions of the employer in enforcing the provisions of the restrictions. For example, if an employee would be considered as having received rights in property subject to a substantial risk of forfeiture, but for the fact that the employee owns 20 percent of the single class of stock in the transferor corporation, and if the remaining 80 percent of the class of stock is owned by an unrelated individual (or members of such an individual's family) so that the possibility of the corporation enforcing a restriction on such rights is substantial, then such rights are subject to a substantial risk of forfeiture. On the other hand, if 4 percent of the voting power of all the stock of a corporation is owned by the president of such corporation and the remaining stock is so diversely held by the public that the president, in effect, controls the corporation, then the possibility of the corporation enforcing a restriction on rights in property transferred to the president is not substantial, and such rights are not subject to a substantial risk of forfeiture.

(4) *Examples.* The rules contained in paragraph (c)(1) of this section may be illustrated by the following examples. In each example it is assumed that, if the conditions on transfer are not satisfied, the forfeiture provision will be enforced.

Example (1). On November 1, 1971, corporation X transfers in connection with the performance of services to E, an employee, 100 shares of corporation X stock for $90 per share. Under the terms of the transfer, E will be subject to a binding commitment to resell the stock to corporation X at $90 per share if he leaves the employment of corporation X for any reason prior to the expiration of a 2-year period from the date of such transfer. Since E must perform substantial services for corporation X and will not be paid more than $90 for the stock, regardless of its value, if he fails to perform such services during such 2-year period, E's rights in the stock are subject to a substantial risk of forfeiture during such period.

Example (2). On November 10, 1971, corporation X transfers in connection with the performance of services to a trust for the benefit of employees, $100*x*. Under the terms of the trust any child of an employee who is an enrolled full-time student at an accredited educational institution as a candidate for a degree will receive an annual grant of cash for each academic year the student completes as a student in good standing, up to a maximum of four years. E, an employee, has a child who is enrolled as a full-time student at an accredited college as a candidate for a degree. Therefore, E has a beneficial interest in the assets of the trust equalling the value of four cash

grants. Since E's child must complete one year of college in order to receive a cash grant, E's interest in the trust assets are subject to a substantial risk of forfeiture to the extent E's child has not become entitled to any grants.

Example (3). On November 25, 1971, corporation X gives to E, an employee, in connection with his performance of services to corporation X, a bonus of 100 shares of corporation X stock. Under the terms of the bonus arrangement E is obligated to return the corporation X stock to corporation X if he terminates his employment for any reason. However, for each year occurring after November 25, 1971, during which E remains employed with corporation X, E ceases to be obligated to return 10 shares of the corporation X stock. Since in each year occurring after November 25, 1971, for which E remains employed he is not required to return 10 shares of corporation X's stock, E's rights in 10 shares each year for 10 years cease to be subject to a substantial risk of forfeiture for each year he remains so employed.

Example (4). (a) Assume the same facts as in example (3) except that for each year occurring after November 25, 1971, for which E remains employed with corporation X, X agrees to pay, in redemption of the bonus shares given to E if he terminates employment for any reason, 10 percent of the fair market value of each share of stock on the date of such termination of employment. Since corporation X will pay E 10 percent of the value of his bonus stock for each of the 10 years after November 25, 1971, in which he remains employed by X, and the risk of a decline in value is not a substantial risk of forfeiture, E's interest in 10 percent of such bonus stock becomes substantially vested in each of those years.

(b) The following chart illustrates the fair market value of the bonus stock and the fair market value of the portion of bonus stock that becomes substantially vested on November 25, for the following years:

Year	Fair market value of	
	All stock	Portion of stock that becomes vested
1972	$200	$20
1973	300	30
1974	150	15
1975	150	15
1976	100	10

If E terminates his employment on July 1, 1977, when the fair market value of the bonus stock is $100, E must return the bonus stock to X, and X must pay, in redemption of the bonus stock, $50 (50 percent of the value of the bonus stock on the date of termination of employment). E has recognized income under section 83(a) and § 1.83-1(a) with respect to 50 percent of the bonus stock, and E's basis in that portion of the stock equals the amount of income recognized, $90. Under § 1.83-1(e), the $40 loss E incurred upon forfeiture ($90 basis less $50 redemption payment) is an ordinary loss.

Example (5). On January 7, 1971, corporation X, a computer service company, transfers to E, 100 shares of corporation X stock for $50. E is a highly compensated salesman who sold X's products in a three-state area since 1960. At the time of transfer each share of X stock has a fair market value of $100. The stock is transferred to E in connection with his termination of employment with X. Each share of X stock is subject to the sole condition that E can keep such share only if he does not engage in competition with X for a 5-year period in the three-state area where E had previously sold X's products. E, who is 45 years old, has no intention of retiring from the work force. In order to earn a salary comparable to his current compensation, while preventing the risk of forfeiture from arising, E will have to expend a substantial amount of time and effort in another industry or market to establish the necessary business contacts. Thus, under these facts and circumstances E's rights in the stock are subject to a substantial risk of forfeiture.

(d) *Transferability of property.* For purposes of section 83 and the regulations thereunder, the rights of a person in property are transferable if such person can transfer any interest in the property to any person other than the transferor of the property, but only if the rights in such property of such transferee are not subject to a substantial risk of forfeiture. Accordingly, property is transferable if the person performing the services or receiving the property can sell, assign, or pledge (as collateral for a loan, or as security for the performance of an obligation, or for any other purpose) his interest in the property to any person other than the transferor of such property and if the transferee is not required to give up the property or its value in the event the substantial risk of forfeiture materializes. On the other hand, property is not considered to be transferable merely because the person performing the services or receiving the property may designate a

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beneficiary to receive the property in the event of his death.

(e) *Property.* For purposes of section 83 and the regulations thereunder, the term "property" includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. The term also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account. See, however, § 1.83-8(a) with respect to employee trusts and annuity plans subject to section 402(b) and section 403(c). In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, only the cash surrender value of the contract is considered to be property. Where rights in a contract providing life insurance protection are substantially nonvested, see § 1.83-1(a)(2) for rules relating to the taxation of the cost of life insurance protection.

(f) *Property transferred in connection with the performance of services.* Property transferred to an employee or an independent contractor (or beneficiary thereof) in recognition of the performance of, or the refraining from performance of, services is considered transferred in connection with the performance of services within the meaning of section 83. The existence of other persons entitled to buy stock on the same terms and conditions as an employee, whether pursuant to a public or private offering may, however, indicate that in such circumstances a transfer to the employee is not in recognition of the performance of, or the refraining from performance of, services. The transfer of property is subject to section 83 whether such transfer is in respect of past, present, or future services.

(g) *Amount paid.* For purposes of section 83 and the regulations thereunder, the term "amount paid" refers to the value of any money or property paid for the transfer of property to which section 83 applies, and does not refer to any amount paid for the right to use such property or to receive the income therefrom. Such value does not include any stated or unstated interest payments. For rules regarding the calculation of the amount of unstated interest payments, see § 1.483-1(c). When section 83 applies to the transfer of property pursuant to the exercise of an option, the term "amount paid" refers to any amount paid for the grant of the option plus any amount paid as the exercise price of the option. For rules regarding the forgiveness of indebtedness treated as an amount paid, see § 1.83-4(c).

(h) *Nonlapse restriction.* For purposes of section 83 and the regulations thereunder, a restriction which by its terms will never lapse (also referred to as a "nonlapse restriction") is a permanent limitation on the transferability of property—

(1) Which will require the transferee of the property to sell, or offer to sell, such property at a price determined under a formula, and

(2) Which will continue to apply to and be enforced against the transferee or any subsequent holder (other than the transferor).

A limitation subjecting the property to a permanent right of first refusal in a particular person at a price determined under a formula is a permanent nonlapse restriction. Limitations imposed by registration requirements of State or Federal security laws or similar laws imposed with respect to sales or other dispositions of stock or securities are not nonlapse restrictions. An obligation to resell or to offer to sell property transferred in connection with the performance of services to a specific person or persons at its fair market value at the time of such sale is not a nonlapse restriction. See § 1.83-5(c) for examples of nonlapse restrictions.

(i) *Lapse restriction.* For purposes of section 83 and the regulations thereunder, the term "lapse restriction" means a restriction other than a nonlapse restriction as defined in paragraph (h) of this section, and includes (but is not limited to) a restriction that carries a substantial risk of forfeiture.

[T.D. 7554, 43 FR 31916, July 24, 1978]

§ 1.83-4 Special rules.

(a) *Holding period.* Under section 83(f), the holding period of transferred property to which section 83(a) applies shall begin just after such property is substantially vested. However, if the person who has performed the services in connection with which property is transferred has made an election under section 83(b), the holding period of such property shall begin just after the date such property is transferred. If property to which section 83 and the regulations thereunder apply is transferred at arm's length, the holding period of such property in the hands of the transferee shall be determined in accordance with the rules provided in section 1223.

(b) *Basis.* (1) Except as provided in paragraph (b)(2) of this section, if property to which section 83 and the regulations thereunder apply is acquired by any person (including a person who acquires such property in a subsequent transfer which is not at arm's length), while such property is still substantially nonvested, such person's basis for the property shall reflect any amount paid for such property and any amount includible in the gross income of the person who performed the services (including any amount so includible as a result of a disposition by the person who acquired such property.) Such basis shall also reflect any adjustments to basis provided under sections 1015 and 1016.

(2) If property to which § 1.83-1 applies is transferred at arm's length, the basis of the property in the hands of the transferee shall be determined under section 1012 and the regulations thereunder.

(c) *Forgiveness of indebtedness treated as an amount paid.* If an indebtedness that has been treated as an amount paid under § 1.83-1(a)(1)(ii) is subsequently cancelled, forgiven or satisfied for an amount less than the amount of such indebtedness, the amount that is not, in fact, paid shall be includible in the gross income of the service provider in the taxable year in which such cancellation, forgiveness or satisfaction occurs.

[T.D. 7554, 43 FR 31918, July 24, 1978]

§ 1.83-5 Restrictions that will never lapse.

(a) *Valuation.* For purposes of section 83 and the regulations thereunder, in the case of property subject to a nonlapse restriction (as defined in § 1.83-3(h)), the price determined under the formula price will be considered to be the fair market value of the property unless established to the contrary by the Commissioner, and the burden of proof shall be on the commissioner with respect to such value. If stock in a corporation is subject to a nonlapse restriction which requires the transferee to sell such stock only at a formula price based on book value, a reasonable multiple of earnings or a reasonable combination thereof, the price so determined will ordinarily be regarded as determinative of the fair market value of such property for purposes of section 83. However, in certain circumstances the formula price will not be considered to be the fair market value of property subject to such a formula price restriction, even though the formula price restriction is a substantial factor in determining such value. For example, where the formula price is the current book value of stock, the book value of the stock at some time in the future may be a more accurate measure of the value of the stock than the current book value of the stock for purposes of determining the fair market value of the stock at the time the stock becomes substantially vested.

(b) *Cancellation*—(1) *In general.* Under section 83(d)(2), if a nonlapse restriction imposed on property that is subject to section 83 is cancelled, then, unless the taxpayer establishes—

(i) That such cancellation was not compensatory, and

(ii) That the person who would be allowed a deduction, if any, if the cancellation were treated as compensatory, will treat the transaction as not compensatory, as provided in paragraph (c)(2) of this section,

the excess of the fair market value of such property (computed without regard to such restriction) at the time of cancellation, over the sum of—

(iii) The fair market value of such property (computed by taking the re-

striction into account) immediately before the cancellation, and

(iv) The amount, if any, paid for the cancellation,

shall be treated as compensation for the taxable year in which such cancellation occurs. Whether there has been a noncompensatory cancellation of a nonlapse restriction under section 83(d)(2) depends upon the particular facts and circumstances. Ordinarily the fact that the employee or independent contractor is required to perform additional services or that the salary or payment of such a person is adjusted to take the cancellation into account indicates that such cancellation has a compensatory purpose. On the other hand, the fact that the original purpose of a restriction no longer exists may indicate that the purpose of such cancellation is non- compensatory. Thus, for example, if a so-called "buy-sell" restriction was imposed on a corporation's stock to limit ownership of such stock and is being cancelled in connection with a public offering of the stock, such cancellation will generally be regarded as noncompensatory. However, the mere fact that the employer is willing to forego a deduction under section 83(h) is insufficient evidence to establish a noncompensatory cancellation of a nonlapse restriction. The refusal by a corporation or shareholder to repurchase stock of the corporation which is subject to a permanent right of first refusal will generally be treated as a cancellation of a nonlapse restriction. The preceding sentence shall not apply where there is no nonlapse restriction, for example, where the price to be paid for the stock subject to the right of first refusal is the fair market value of the stock. Section 83(d)(2) and this (1) do not apply where immediately after the cancellation of a nonlapse restriction the property is still substantially nonvested and no section 83(b) election has been made with respect to such property. In such a case the rules of section 83(a) and § 1.83-1 shall apply to such property.

(2) *Evidence of noncompensatory cancellation.* In addition to the information necessary to establish the factors described in paragraph (b)(1) of this section, the taxpayer shall request the employer to furnish the taxpayer with a written statement indicating that the employer will not treat the cancellation of the nonlapse restriction as a compensatory event, and that no deduction will be taken with respect to such cancellation. The taxpayer shall file such written statement with his income tax return for the taxable year in which or with which such cancellation occurs.

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). On November 1, 1971, X corporation whose shares are closely held and not regularly traded, transfers to E, an employee, 100 shares of X corporation stock subject to the condition that, if he desires to dispose of such stock during the period of his employment, he must resell the stock to his employer at its then existing book value. In addition, E or E's estate is obligated to offer to sell the stock at his retirement or death to his employer at its then existing book value. Under these facts and circumstances, the restriction to which the shares of X corporation stock are subject is a nonlapse restriction. Consequently, the fair market value of the X stock is includible in E's gross income as compensation for taxable year 1971. However, in determining the fair market value of the X stock, the book value formula price will ordinarily be regarded as being determinative of such value.

Example (2). Assume the facts are the same as in example (1), except that the X stock is subject to the condition that if E desires to dispose of the stock during the period of his employment he must resell the stock to his employer at a multiple of earnings per share that is in this case a reasonable approximation of value at the time of transfer to E. In addition, E or E's estate is obligated to offer to sell the stock at his retirement or death to his employer at the same multiple of earnings. Under these facts and circumstances, the restriction to which the X corporation stock is subject is a nonlapse restriction. Consequently, the fair market value of the X stock is includible in E's gross income for taxable year 1971. However, in determining the fair market value of the X stock, the multiple-of-earnings formula price will ordinarily be regarded as determinative of such value.

Example (3). On January 4, 1971, X corporation transfers to E, an employee, 100 shares of stock in X corporation. Each such share of stock is subject to an agreement between X and E whereby E agrees that such shares are to be held solely for investment purposes and not for resale (a so-called investment letter restriction). E's rights in

such stock are substantially vested upon transfer, causing the fair market value of each share of X corporation stock to be includible in E's gross income as compensation for taxable year 1971. Since such an investment letter restriction does not constitute a nonlapse restriction, in determining the fair market value of each share, the investment letter restriction is disregarded.

Example (4). On September 1, 1971, X corporation transfers to B, an independent contractor, 500 shares of common stock in X corporation in exchange for B's agreement to provide services in the construction of an office building on property owned by X corporation. X corporation has 100 shares of preferred stock outstanding and an additional 500 shares of common stock outstanding. The preferred stock has a liquidation value of $1,000*x*, which is equal to the value of all assets owned by X. Therefore, the book value of the common stock in X corporation is $0. Under the terms of the transfer, if B wishes to dispose of the stock, B must offer to sell the stock to X for 150 percent of the then existing book value of B's common stock. The stock is also subject to a substantial risk of forfeiture until B performs the agreed-upon services. B makes a timely election under section 83(b) to include the value of the stock in gross income in 1971. Under these facts and circumstances, the restriction to which the shares of X corporation common stock are subject is a nonlapse restriction. In determining the fair market value of the X common stock at the time of transfer, the book value formula price would ordinarily be regarded as determinative of such value. However, the fair market value of X common stock at the time of transfer, subject to the book value restriction, is greater than $0 since B was willing to agree to provide valuable personal services in exchange for the stock. In determining the fair market value of the stock, the expected book value after construction of the office building would be given great weight. The likelihood of completion of construction would be a factor in determining the expected book value after completion of construction.

[T.D. 7554, 43 FR 31918, July 24, 1978]

§ 1.83-6 Deduction by employer.

(a) *Allowance of deduction*—(1) *General rule.* In the case of a transfer of property in connection with the performance of services, or a compensatory cancellation of a nonlapse restriction described in section 83(d) and § 1.83-5, a deduction is allowable under sections 162 or 212, to the person for whom such services were performed. The amount of the deduction is equal to the amount includible as compensation in the gross income of the service provider, under section 83 (a), (b), or (d)(2), but only to the extent such amount meets the requirements of sections 162 or 212 and the regulations thereunder. Such deduction shall be allowed only for the taxable year of such person in which or with which ends the taxable year of the service provider in which such amount is includible as compensation. For purposes of this paragraph, any amount excluded from gross income under section 79 or section 101(b) or subchapter N shall be considered to have been includible in gross income.

(2) *Special rule.* If the service provider is an employee of the person for whom services were performed, such deduction is allowed for the taxable year of the employer in which or with which ends the taxable year of the employee in which such amount is includible as compensation, but only if the employer deducts and withholds upon such amount in accordance with section 3402. A deduction will not be disallowed under the preceeding sentence if the employer does not withhold and deduct upon amounts excluded from gross income, such as amounts excluded under section 79, section 101(b), or subchapter N. For taxable years of employees ending before July 21, 1978, such deduction is allowed for the taxable year of the employer in which or with which ends the taxable year of the employee in which such amount is includible as compensation, if either the employer deducts and withholds upon such amount in accordance with section 3402 or the employee includes such amount in gross income as compensation for such taxable year of the employee.

(3) *Exceptions.* Where property is substantially vested upon transfer, the deduction shall be allowed to such person in accordance with his method of accounting (in conformity with sections 446 and 461). In the case of a transfer to an employee benefit plan described in § 1.162-10(a) or a transfer to an employees' trust or annuity plan described in section 404(a)(5) and the regulations thereunder, section 83(h) and this section do not apply.

(4) *Capital expenditure, etc.* No deduction is allowed under section 83(h) to the extent that the transfer of property constitutes a capital expenditure, an item of deferred expense, or an amount properly includible in the value of inventory items. In the case of a capital expenditure, for example, the basis of the property to which such capital expenditure relates shall be increased at the same time and to the same extent as any amount includible in the employee's gross income in respect of such transfer. Thus, for example, no deduction is allowed to a corporation in respect of a transfer of its stock to a promoter upon its organization, notwithstanding that such promoter must include the value of such stock in his gross income in accordance with the rules under section 83.

(b) *Recognition of gain or loss.* Except as provided in section 1032, at the time of a transfer of property in connection with the performance of services the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor's basis in the property. In addition, at the time a deduction is allowed under section 83(h) and paragraph (a) of this section, gain or loss is recognized to the extent of the difference between (i) the sum of the amount paid plus the amount allowed as a deduction under section 83(h), and (ii) the sum of the taxpayer's basis in the property plus any amount recognized pursuant to the previous sentence.

(c) *Forfeitures.* If, under section 83(h) and paragraph (a) of this section, a deduction, an increase in basis, or a reduction of gross income was allowable (disregarding the reasonableness of the amount of compensation) in respect of a transfer of property and such property is subsequently forfeited, the amount of such deduction, increase in basis or reduction of gross income shall be includible in the gross income of the person to whom it was allowable for the taxable year of forfeiture. The basis of such property in the hands of the person to whom it is forfeited shall include any such amount includible in the gross income of such person, as well as any amount such person pays upon forfeiture.

(d) *Special rules for transfers by shareholders*—(1) *Transfers.* If a shareholder of a corporation transfers property to an employee of such corporation or to an independent contractor (or to a beneficiary thereof), in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property by the corporation to the employee or independent contractor under paragraphs (a) and (b) of this section. For purposes of this (1), such a transfer will be considered to be in consideration for services performed for the corporation if either the property transferred is substantially nonvested at the time of transfer or an amount is includible in the gross income of the employee or independent contractor at the time of transfer under § 1.83-1(a)(1) or § 1.83-2(a). In the case of such a transfer, any money or other property paid to the shareholder for such stock shall be considered to be paid to the corporation and transferred immediately thereafter by the corporation to the shareholder as a distribution to which section 302 applies.

(2) *Forfeiture.* If, following a transaction described in paragraph (d)(1) of this section, the transferred property is forfeited to the shareholder, paragraph (c) of this section shall apply both with respect to the shareholder and with respect to the corporation. In addition, the corporation shall in the taxable year of forfeiture be allowed a loss (or realize a gain) to offset any gain (or loss) realized under paragraph (b) of this section. For example, if a shareholder transfers property to an employee of the corporation as compensation, and as a result the shareholder's basis of $\$200x$ in such property is allocated to his stock in such corporation and such corporation recognizes a short-term capital gain of $\$800x$, and is allowed a deduction of $\$1{,}000x$ on such transfer, upon a subsequent forfeiture of the property to the shareholder, the shareholder shall take $\$200x$ into gross income, and the corporation shall take $\$1{,}000x$ into

gross income and be allowed a short-term capital loss of $800x.

(e) *Options.* [Reserved]

(f) *Reporting requirements.* [Reserved]

[T.D. 7554, 43 FR 31919, July 24, 1978]

§ 1.83-7 Taxation of nonqualified stock options.

(a) *In general.* If there is granted to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services, an option to which section 421 (relating generally to certain qualified and other options) does not apply, section 83(a) shall apply to such grant if the option has a readily ascertainable fair market value (determined in accordance with paragraph (b) of this section) at the time the option is granted. The person who performed such services realizes compensation upon such grant at the time and in the amount determined under section 83(a). If section 83(a) does not apply to the grant of such an option because the option does not have a readily ascertainable fair market value at the time of grant, sections 83(a) and 83(b) shall apply at the time the option is exercised or otherwise disposed of, even though the fair market value of such option may have become readily ascertainable before such time. If the option is exercised, sections 83(a) and 83(b) apply to the transfer of property pursuant to such exercise, and the employee or independent contractor realizes compensation upon such transfer at the time and in the amount determined under section 83(a) or 83(b). If the option is sold or otherwise disposed of in an arm's length transaction, sections 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as sections 83(a) and 83(b) would have applied to the transfer of property pursuant to an exercise of the option.

(b) *Readily ascertainable defined—*(1) *Actively traded on an established market.* Options have a value at the time they are granted, but that value is ordinarily not readily ascertainable unless the option is actively traded on an established market. If an option is actively traded on an established market, the fair market value of such option is readily ascertainable for purposes of this section by applying the rules of valuation set forth in § 20.2031-2.

(2) *Not actively traded on an established market.* When an option is not actively traded on an established market, it does not have a readily ascertainable fair market value unless its fair market value can otherwise be measured with reasonable accuracy. For purposes of this section, if an option is not actively traded on an established market, the option does not have a readily ascertainable fair market value when granted unless the taxpayer can show that all of the following conditions exist:

(i) The option is transferable by the optionee;

(ii) The option is exerciseable immediately in full by the optionee;

(iii) The option or the property subject to the option is not subject to any restriction or condition (other than a lien or other condition to secure the payment of the purchase price) which has a significant effect upon the fair market value of the option; and

(iv) The fair market value of the option privilege is readily ascertainable in accordance with paragraph (b)(3) of this section.

(3) *Option privilege.* The option privilege in the case of an option to buy is the opportunity to benefit during the option's exercise period from any increase in the value of property subject to the option during such period, without risking any capital. Similarly, the option privilege in the case of an option to sell is the opportunity to benefit during the exercise period from a decrease in the value of property subject to the option. For example, if at some time during the exercise period of an option to buy, the fair market value of the property subject to the option is greater than the option's exercise price, a profit may be realized by exercising the option and immediately selling the property so acquired for its higher fair market value. Irrespective of whether any such gain may be realized immediately at the time an option is granted, the fair market value of an option to buy includes the value of the right to benefit from any future increase in the value

of the property subject to the option (relative to the option exercise price), without risking any capital. Therefore, the fair market value of an option is not merely the difference that may exist at a particular time between the option's exercise price and the value of the property subject to the option, but also includes the value of the option privilege for the remainder of the exercise period. Accordingly, for purposes of this section, in determining whether the fair market value of an option is readily ascertainable, it is necessary to consider whether the value of the entire option privilege can be measured with reasonable accuracy. In determining whether the value of the option privilege is readily ascertainable, and in determining the amount of such value when such value is readily ascertainable, it is necessary to consider—

(i) Whether the value of the property subject to the option can be ascertained;

(ii) The probability of any ascertainable value of such property increasing or decreasing; and

(iii) The length of the period during which the option can be exercised.

(c) *Reporting requirements.* [Reserved]

[T.D. 7554, 43 FR 31920, July 24, 1978]

§ 1.83-8 Applicability of section and transitional rules.

(a) *Scope of section 83.* Section 83 is not applicable to—

(1) A transaction concerning an option to which section 421 applies;

(2) A transfer to or from a trust described in section 401(a) for the benefit of employees or their beneficiaries, or a transfer under an annuity plan that meets the requirements of section 404(a)(2) for the benefit of employees or their beneficiaries;

(3) The transfer of an option without a readily ascertainable fair market value (as defined in § 1.83-7(b)(1)); or

(4) The transfer of property pursuant to the exercise of an option with a readily ascertainable fair market value at the date of grant. Section 83 applies to a transfer to or from a trust or under an annuity plan for the benefit of employees, independent contractors, or their beneficiaries (except as provided in paragraph (a)(2) of this section), but to the extent a transfer is subject to section 402(b) or 403(c), section 83 applies to such a transfer only as provided for in section 402(b) or 403(c).

(b) *Transitional rules*—(1) *In general.* Except as otherwise provided in this paragraph, section 83 and the regulations thereunder shall apply to property transferred after June 30, 1969.

(2) *Binding written contracts.* Section 83 and the regulations thereunder shall not apply to property transferred pursuant to a binding written contract entered into before April 22, 1969. For purposes of this paragraph, a binding written contract means only a written contract under which the employee or independent contractor has an enforceable right to compel the transfer of property or to obtain damages upon the breach of such contract. A contract which provides that a person's right to such property is contingent upon the happening of an event (including the passage of time) may satisfy the requirements of this paragraph. However, if the event itself, or the determination of whether the event has occurred, rests with the board of directors or any other individual or group acting on behalf of the employer (other than an arbitrator), the contract will not be treated as giving the person an enforceable right for purposes of this paragraph.

The fact that the board of directors has the power (either expressly or impliedly) to terminate employment of an officer pursuant to a contract that contemplates the completion of services over a fixed or ascertainable period does not negate the existence of a binding written contract. Nor will the binding nature of the contract be negated by a provision in such contract which allows the employee or independent contractor to terminate the contract for any year and receive cash instead of property if such election would cause a substantial penalty, such as a forfeiture of part or all of the property received in connection with the performance of services in an earlier year.

(3) *Options granted before April 22, 1969.* Section 83 shall not apply to

property received upon the exercise of an option granted before April 22, 1969.

(4) *Certain written plans.* Section 83 shall not apply to property transferred (whether or not by the exercise of an option) before May 1, 1970, pursuant to a written plan adopted and approved before July 1, 1969. A plan is to be considered as having been adopted and approved before July 1, 1969, only if prior to such date the transferor of the property undertook an ascertainable course of conduct which under applicable State law does not require further approval by the board of directors or the stockholders of any corporation. For example, if a corporation transfers property to an employee in connection with the performance of services pursuant to a plan adopted and approved before July 1, 1969, by the board of directors of such corporation, it is not necessary that the stockholders have adopted or approved such plan if State law does not require such approval. However, such approval is necessary if required by the articles of incorporation or the bylaws or if, by its terms, such plan will not become effective without such approval.

(5) *Certain options granted pursuant to a binding written contract.* Section 83 shall not apply to property transferred before January 1, 1973, upon the exercise of an option granted pursuant to a binding written contract (as defined in paragraph (b)(2) of this section) entered into before April 22, 1969, between a corporation and the transferor of such property requiring the transferor to grant options to employees of such corporation (or a subsidiary of such corporation) to purchase a determinable number of shares of stock of such corporation, but only if the transferee was an employee of such corporation (or a subsidiary of such corporation) on or before April 22, 1969.

(6) *Certain tax free exchanges.* Section 83 shall not apply to property transferred in exchange for (or pursuant to the exercise of a conversion privilege contained in) property transferred before July 1, 1969, or in exchange for property to which section 83 does not apply (by reason of paragraphs (1), (2), (3), or (4) of section 83(i)), if section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) applies, or if gain or loss is not otherwise required to be recognized upon the exercise of such conversion privilege, and if the property received in such exchange is subject to restrictions and conditions substantially similar to those to which the property given in such exchange was subject.

[T.D. 7554, 43 FR 31921, July 24, 1978]

EDITORIAL NOTE: The text of § 1.85–1 added at 45 FR 46069, July 9, 1980 appears following § 1.84–1.

§ 1.84–1 Transfer of appreciated property to political organizations.

(a) *Transfer defined.* A transfer after May 7, 1974, of property to a political organization (as defined in section 527(e)(1), and including a newsletter fund to the extent provided under section 527(g)) is treated as a sale of the property to the political organization if the fair market value of the property exceeds its adjusted basis. The transferor is treated as having realized an amount equal to the fair market value of the property on the date of the transfer. For purposes of this section, a transfer is any assignment, conveyance, or delivery of property other than a bona fide sale for an adequate and full consideration in money or money's worth, whether the transfer is in trust or otherwise, whether the transfer is direct or indirect and whether the property is real or personal, tangible or intangible. Thus, for example, a sale at less than fair market value (other than an ordinary trade discount), or a receipt of property by a political organization under an agency agreement entitling the organization to sell the property and retain all or a portion of the proceeds of the sale, is a transfer within the meaning, of this section. The term "transfer" also includes an illegal contribution of property.

(b) *Amount realized.* A transferor to whom this section applies realizes an amount equal to the fair market value of the property on the date of the transfer. For purposes of this section, the definition of fair market value set forth in § 1.170A–1(c) (2) and (3) is incorporated by reference.

(c) *Amount recognized.* A transferor to whom this section applies is treated

as having sold the property to the political organization on the date of the transfer. Therefore, the rules of chapter 1 of subtitle A (relating to income tax) apply to the gain realized under this section as if this gain were an amount realized upon the sale of the property. These rules include those of section 55 and section 56 (relating to minimum tax for tax preference), section 306 (relating to disposition of certain stock), section 1201 (relating to the alternative tax on certain capital gains), section 1245 (relating to gain from dispositions of certain depreciable property), and section 1250 (relating to gain from dispositions of certain depreciable realty).

(d) *Holding period.* The holding period of property transferred to a political organization to which this section applies begins on the day after the date of acquisition of the property by the political organization.

[T.D. 7671, 45 FR 8003, Feb. 6, 1980]

§ 1.85–1 Unemployment compensation.

(a) *Introduction.* Section 85 prescribes rules relating to the inclusion in gross income of unemployment compensation (as defined in paragraph (b)(1) of this section) paid in taxable years beginning after December 31, 1978 pursuant to governmental programs. In general, these rules provide that unemployment compensation paid pursuant to governmental programs is includible in the gross income of a taxpayer if the taxpayer's modified adjusted gross income (as defined in paragraph (b)(2) of this section) exceeds a statutory base amount (as defined in paragraph (b)(3) of this section). If there is such an excess, however, the amount included in gross income is limited under paragraph (c)(1) of this section to the lesser of one-half of such excess or the amount of the unemployment compensation. If such taxpayer's modified adjusted gross income does not exceed the applicable statutory base amount, none of the unemployment compensation is included in the taxpayer's gross income.

(b) *Definitions*—(1) *Unemployment compensation*—(i) *General rule.* Except as provided in paragraph (b)(1)(iii) of this section, the term "unemployment compensation" means any amount received under a law of the United States, or of a State, which is in the nature of unemployment compensation. Thus, section 85 applies only to unemployment compensation paid pursuant to governmental programs and does not apply to amounts paid pursuant to private nongovernmental unemployment compensation plans (which are includible in income without regard to section 85). Generally, unemployment compensation programs are those designed to protect taxpayers against the loss of income caused by involuntary layoff. Ordinarily, unemployment compensation is paid in cash and on a periodic basis. The amount of the payments is usually computed in accordance with formula based on the taxpayer's length of prior employment and wages. Such payments, however, may be made in a lump sum or other than in cash or on some other basis.

(ii) *Disability and worker's compensation payments.* Amounts in the nature of unemployment compensation also include cash disability payments made pursuant to a governmental program as a substitute for case unemployment payments to an unemployed taxpayer who is ineligible for such payments solely because of the disability. Usually these disability payments are paid in the same weekly amount and for the same period as the unemployment compensation benefits to which the unemployed taxpayer otherwise would have been entitled. Amounts received under workmen's compensation acts as compensation for personal injuries or sickness are not amounts in the nature of unemployment compensation. See section 104(a)(1) relating to the exclusion from gross income of such amounts.

(iii) *Employee contributions to a governmental plan.* If a governmental unemployment compensation program is funded in part by an employee's contribution which is not deductible by the employee, an amount paid to such employee under the program is not to be considered unemployment compensation until an amount equal to the total nondeductible contributions paid by the employee to such

program has been paid to such employee.

(iv) *Examples of governmental unemployment compensation programs.* Governmental unemployment compensation programs include (but are not limited to) programs established under:

(A) A State law approved by the Secretary of Labor pursuant to section 3304 of the Internal Revenue Code of 1954.

(B) Chapter 85 of Title 5, United States Code, relating to unemployment compensation for Federal employees generally and for ex-servicemen.

(C) Trade Act of 1974, sections 231 and 232 (19 U.S.C. 2291 and 2292).

(D) Disaster Relief Act of 1974, section 407 (42 U.S.C. 5177).

(E) The Airline Deregulation Act of 1978 (49 U.S.C. 1552(b)).

(F) The Railroad Unemployment Insurance Act, section 2 (45 U.S.C. 352).

(2) *Modified adjusted gross income.* The term "modified adjusted gross income" means the sum of the following amounts:

(i) Adjusted gross income (as defined in section 62);

(ii) All disability payments of the type that are eligible for exclusion from gross income under section 105(d); and

(iii) All amounts of unemployment compensation (as defined in paragraph (b)(1) of this section).

(3) *Base amount.* The term "base amount" means—

(i) $25,000 in the case of a joint return under section 6013.

(ii) Zero in the case of a taxpayer who—

(A) Is married (within the meaning of section 143) at the close of the taxable year,

(B) Does not file a joint return for such taxable year, and

(C) Does not live apart (as defined in paragraph (b)(4) of this section) from his or her spouse at all times during the taxable year.

(iii) $20,000 in the case of all other taxpayers.

(4) *Living apart.* A taxpayer does not "live apart" from his or her spouse at all times during a taxable year if for any period during the taxable year the taxpayer is a member of the same household as such taxpayer's spouse. A taxpayer is a member of a household for any period, including temporary absences due to special circumstances, during which the household is the taxpayer's place of abode. A temporary absence due to special circumstances includes a nonpermanent absence caused by illness, education, business, vacation, or military service.

(c) *Limitations*—(1) *General rule.* If for a taxable year, a taxpayer's modified adjusted gross income does not exceed the applicable statutory base amount, no amount of unemployment compensation is included in gross income for the taxable year. If there is such an excess, the taxpayer includes in gross income for the taxable year the lesser of the following:

(i) One-half of the excess of the taxpayer's modified adjusted gross income over such taxpayer's base amount, or

(ii) The amount of unemployment compensation.

(2) *Exception for fraudulently received unemployment compensation.* If a taxpayer fraudulently receives unemployment compensation under any governmental unemployment compensation program, then the entire amount of such fraudulently received unemployment compensation must be included in the taxpayer's gross income for the taxable year in which the benefits were received. Thus, the limitation in section 85 and in paragraph (c)(1) of this section, does not apply to such amounts.

(3) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example (1). H and W are married taxpayers who for calendar year 1979 file a joint income tax return. During 1979 H receives $4,500 of disability income that is eligible for an exclusion under section 105(d). W works for part of 1979 and receives $20,000 as compensation and also receives $5,000 of unemployment compensation in 1979. Assume that H and W's adjusted gross income is $20,000. The modified adjusted gross income of H and W is $29,500 ($4,500 + $20,000 + $5,000). Since their modified adjusted gross income ($29,500) is greater than their base amount ($25,000), some of the unemployment compensation received by W must be included in their gross income

on their 1979 joint income tax return. Under paragraph (c)(1) of this section, of the $5,000 which is unemployment compensation, the lesser of $2,250 (($29,500—$25,000)÷2) or $5,000 must be included in their gross income. Thus, $2,250 of the $5,000 received by W in 1979 is included in the gross income of H and W on their joint income tax return for 1979.

Example (2). Assume the same facts in example (1) except H received $5,000 of disability income that is eligible for an exclusion under section 105(d) and W receives $28,000 as compensation, and $4,000 which is unemployment compensation. Assume that H and W's adjusted gross income is $28,000. The modified adjusted gross income of H and W is $37,000 ($4,000 + $28,000 + $5,000). Since their modified adjusted gross income ($37,000) is greater than their base amount ($25,000), all of the unemployment compensation received by W must be included in their gross income on their 1979 joint income tax return. Under paragraph (c)(1) of this section, of the $4,000 which is unemployment compensation, the lesser of $6,000 (($37,000—$25,000)÷2) or $4,000 must be included in their gross income. Thus, all of the $4,000 unemployment compensation received by W is included in the gross income of H and W on their joint income tax return for 1979.

(d) *Cross reference.* See section 6050B, relating to the requirement that every person who makes payments of unemployment compensation aggregating $10 or more to any individual during any calendar year file an information return with the Interal Revenue Service.

[T.D. 7705, 45 FR 46069, July 9, 1980]

Items Specifically Excluded From Gross Income

§ 1.101-1 Exclusion from gross income of proceeds of life insurance contracts payable by reason of death.

(a) (1) *In general.* Section 101(a)(1) states the general rule that the proceeds of life insurance policies, if paid by reason of the death of the insured, are excluded from the gross income of the recipient. Death benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen's compensation insurance contracts, endowment contracts, or accident and health insurance contracts, are covered by this provision. For provisions relating to death benefits paid by or on behalf of employers, see section 101(b) and § 1.101-2. The exclusion from gross income allowed by section 101(a) applies whether payment is made to the estate of the insured or to any beneficiary (individual, corporation, or partnership) and whether it is made directly or in trust. The extent to which this exclusion applies in cases where life insurance policies have been transferred for a valuable consideration is stated in section 101(a)(2) and in paragraph (b) of this section. In cases where the proceeds of a life insurance policy, payable by reason of the death of the insured, are paid other than in a single sum at the time of such death, the amounts to be excluded from gross income may be affected by the provisions of section 101 (c) (relating to amounts held under agreements to pay interest) or section 101(d) (relating to amounts payable at a date later than death). See §§ 1.101-3 and 1.101-4. However, neither section 101(c) nor section 101(d) applies to a single sum payment which does not exceed the amount payable at the time of death even though such amount is actually paid at a date later than death.

(2) *Cross references.* For rules governing the taxability of insurance proceeds constituting benefits payable on the death of an employee—

(i) Under pension, profit-sharing, or stock bonus plans described in section 401(a) and exempt from tax under section 501(a), or under annuity plans described in section 403(a), see section 72 (m)(3) and paragraph (c) of § 1.72-16; or

(ii) Under annuity contracts to which paragraph (a) or (b) of § 1.403(b)-1 applies, see paragraph (c)(3) of § 1.403(b)-1.

For the definition of a life insurance company, see section 801.

(b) *Transfers of life insurance policies.* (1) In the case of a transfer, by assignment or otherwise, of a life insurance policy or any interest therein for a valuable consideration, the amount of the proceeds attributable to such policy or interest which is excludable from the transferee's gross income is generally limited to the sum of (i) the actual value of the considera-

tion for such transfer, and (ii) the premiums and other amounts subsequently paid by the transferee (see section 101 (a) (2) and example (1) of subparagraph (5) of this paragraph). However, this limitation on the amount excludable from the transferee's gross income does not apply (except in certain special cases involving a series of transfers), where the basis of the policy or interest transferred, for the purpose of determining gain or loss with respect to the transferee, is determinable, in whole or in part, by reference to the basis of such policy or interest in the hands of the transferor (see section 101 (a) (2) (A) and examples (2) and (4) of subparagraph (5) of this paragraph). Neither does the limitation apply where the policy or interest therein is transferred to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer (see section 101 (a) (2) (B)). For rules relating to gratuitous transfers, see subparagraph (2) of this paragraph. For special rules with respect to certain cases where a series of transfers is involved, see subparagraph (3) of this paragraph.

(2) In the case of a gratuitous transfer, by assignment or otherwise, of a life insurance policy or any interest therein, as a general rule the amount of the proceeds attributable to such policy or interest which is excludable from the transferee's gross income under section 101 (a) is limited to the sum of (i) the amount which would have been excludable by the transferor (in accordance with this section) if no such transfer had taken place, and (ii) any premiums and other amounts subsequently paid by the transferee. See example (6) of subparagraph (5) of this paragraph. However, where the gratuitous transfer in question is made by or to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer, the entire amount of the proceeds attributable to the policy or interest transferred shall be excludable from the transferee's gross income (see section 101 (a) (2) (B) and example (7) of subparagraph (5) of this paragraph).

(3) In the case of a series of transfers, if the last transfer of a life insurance policy or an interest therein is for a valuable consideration—

(i) The general rule is that the final transferee shall exclude from gross income, with respect to the proceeds of such policy or interest therein, only the sum of—

(*a*) The actual value of the consideration paid by him, and

(*b*) The premiums and other amounts subsequently paid by him;

(ii) If the final transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer, the final transferee shall exclude the entire amount of the proceeds from gross income;

(iii) Except where subdivision (ii) of this subparagraph applies, if the basis of the policy or interest transferred, for the purpose of determining gain or loss with respect to the final transferee, is determinable, in whole or in part, by reference to the basis of such policy or interest therein in the hands of the transferor, the amount of the proceeds which is excludable by the final transferee is limited to the sum of—

(*a*) The amount which would have been excludable by his transferor if no such transfer had taken place, and

(*b*) Any premiums and other amounts subsequently paid by the final transferee himself.

(4) For the purposes of section 101 (a) (2) and subparagraphs (1) and (3) of this paragraph, a "transfer for a valuable consideration" is any absolute transfer for value of a right to receive all or a part of the proceeds of a life insurance policy. Thus, the creation, for value, of an enforceable contractual right to receive all or a part of the proceeds of a policy may constitute a transfer for a valuable consideration of the policy or an interest therein. On the other hand, the pledging or assignment of a policy as collateral security is not a transfer for a valuable consideration of such policy or an interest therein, and section 101 is

inapplicable to any amounts received by the pledgee or assignee.

(5) The application of this paragraph may be illustrated by the following examples:

Example (1). A pays premiums of $500 for an insurance policy in the face amount of $1,000 upon the life of B, and subsequently transfers the policy to C for $600. C receives the proceeds of $1,000 upon the death of B. The amount which C can exclude from his gross income is limited to $600 plus any premiums paid by C subsequent to the transfer.

Example (2). The X Corporation purchases for a single premium of $500 an insurance policy in the face amount of $1,000 upon the life of A, one of its employees, naming the X Corporation as beneficiary. The X Corporation transfers the policy to the Y Corporation in a tax-free reorganization (the policy having a basis for determining gain or loss in the hands of the Y Corporation determined by reference to its basis in the hands of the X Corporation). The Y Corporation receives the proceeds of $1,000 upon the death of A. The entire $1,000 is to be excluded from the gross income of the Y Corporation.

Example (3). The facts are the same as in example (2) except that, prior to the death of A, the Y Corporation transfers the policy to the Z Corporation for $600. The Z Corporation receives the proceeds of $1,000 upon the death of A. The amount which the Z Corporation can exclude from its gross income is limited to $600 plus any premiums paid by the Z Corporation subsequent to the transfer of the policy to it.

Example (4). The facts are the same as in example (3) except that, prior to the death of A, the Z Corporation transfers the policy to the M Corporation in a tax-free reorganization (the policy having a basis for determining gain or loss in the hands of the M Corporation determined by reference to its basis in the hands of the Z Corporation). The M Corporation receives the proceeds of $1,000 upon the death of A. The amount which the M Corporation can exclude from its gross income is limited to $600 plus any premiums paid by the Z Corporation and the M Corporation subsequent to the transfer of the policy to the Z Corporation.

Example (5). The facts are the same as in example (3) except that, prior to the death of A, the Z Corporation transfers the policy to the N Corporation, in which A is a shareholder. The N Corporation receives the proceeds of $1,000 upon the death of A. The entire $1,000 is to be excluded from the gross income of the N Corporation.

Example (6). A pays premiums of $500 for an insurance policy in the face amount of $1,000 upon his own life, and subsequently transfers the policy to his wife B for $600. B later transfers the policy without consideration to C, who is the son of A and B. C receives the proceeds of $1,000 upon the death of A. The amount which C can exclude from his gross income is limited to $600 plus any premiums paid by B and C subsequent to the transfer of the policy to B.

Example (7). The facts are the same as in example (6) except that, prior to the death of A, C transfers the policy without consideration to A, the insured. A's estate receives the proceeds of $1,000 upon the death of A. The entire $1,000 is to be excluded from the gross income of A's estate.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6783, 29 FR 18356, Dec. 24, 1964]

§ 1.101-2 Employees' death benefits.

(a) *In general.* (1) Section 101(b) states the general rule that amounts up to $5,000 which are paid to the beneficiaries or the estate of an employee, or former employee, by or on behalf of an employer and by reason of the death of the employee shall be excluded from the gross income of the recipient. This exclusion from gross income applies whether payment is made to the estate of the employee or to any beneficiary (individual, corporation, or partnership), whether it is made directly or in trust, and whether or not it is made pursuant to a contractual obligation of the employer. The exclusion applies whether payment is made in a single sum or otherwise, subject to the provisions of section 101 (c), relating to amounts held under an agreement to pay interest thereon (see § 1.101-3). The exclusion from gross income also applies to any amount not actually paid which is otherwise taxable to a beneficiary of an employee because it was made available as a distribution from an employee's trust.

(2) The exclusion does not apply to amounts constituting income payable to the employee during his life as compensation for his services, such as bonuses or payments for unused leave or uncollected salary, nor to certain other amounts with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living (see section 101(b)(2)(B) and paragraph (d) of this section). Further, the exclusion does not apply to amounts received as an annuity

under a joint and survivor annuity obligation where the employee was the primary annuitant and the annuity starting date occurred before the death of the employee (see section 101 (b)(2)(C) and paragraph (e)(1)(ii) of this section). In the case of amounts received by a beneficiary as an annuity (but not as a survivor under a joint and survivor annuity with respect to which the employee was the primary annuitant), the exclusion is applied indirectly by means of the provisions of section 72 and the regulations thereunder (see section 101(b)(2)(D) and paragraph (e) (1) (iii) and (iv) of this section). Thus, for example, the exclusion applies to amounts which are received by a survivor of an employee retired on disability under the provisions of the Civil Service retirement law (5 U.S.C. 8301 or any former corresponding provisions of law) or the Retired Serviceman's Family Protection Plan or Survivor Benefit Plan (10 U.S.C. 1431 et seq.), provided such employee dies before attaining mandatory retirement age (as defined in § 1.105-4 (a)(3)(i)(B)).

(3) The total amount excludable with respect to any employee may not exceed $5,000, regardless of the number of employers or the number of beneficiaries. For allocation of the exclusion among beneficiaries, see paragraph (c) of this section. For rules governing the taxability of benefits payable on the death of an employee under pension, profitsharing, or stock bonus plans described in section 401(a) and exempt under section 501(a), under annuity plans described in section 403(a), or under annuity contracts to which paragraph (a) or (b) of § 1.403(b)-1 applies, see sections 72(m)(3), 402(a), and 403 and the regulations thereunder.

(b) *Payments under certain employee benefit plans*—(1) *In general.* Where a payment is made by reason of the death of an employee by an employer-provided welfare fund or a trust, including a stock bonus, pension, or profitsharing trust described in section 401 (a), or by an insurance company (if such payment does not constitute "life insurance" within the purview of section 101(a), the payment shall be considered to have been made by or on behalf of the employer to the extent that it exceeds amounts contributed by, or deemed contributed by, the deceased employee.

(2) *Cross references.* For provisions governing the taxability of distributions payable on the death of an employee participant—

(i) Under a trust described in section 401(a) and exempt from tax under section 501(a), see paragraph (c) of § 1.72-16 and paragraph (a)(5) of § 1.402 (a)-1;

(ii) Under an annuity plan described in section 403(a), see paragraph (c) of § 1.72-16 and paragraph (c) of § 1.403 (a)-1;

(iii) Under annuity contracts to which paragraph (a) or (b) of § 1.403 (b)-1 applies, see paragraph (c) (2) and (3) of § 1.403(b)-1.

(c) *Allocation of the exclusion.* (1) Where the aggregate payments by or on behalf of an employer or employers as death benefits to the beneficiaries or the estate of a deceased employee exceed $5,000, the $5,000 exclusion shall be apportioned among them in the same proportion as the amount received by or the present value of the amount payable to each bears to the total death benefits paid or payable by or on behalf of the employer or employers.

(2) The application of the rule in subparagraph (1) of this paragraph may be illustrated by the following example:

Example. The M Corporation, the employer of A, a deceased employee who died November 30, 1954, makes payments in 1955 to the beneficiaries of A as follows: $5,000 to W, A's widow, $2,000 to B, the son of A, and $3,000 to C, the daughter of A. No other amounts are paid by any other employer of A to his estate or beneficiaries. By application of the apportionment rule stated above, W, the widow, will exclude $2,500 ($5,000/$10,000, or one-half, of $5,000); B, the son, will exclude $1,000 ($2,000/$10,000, or one-fifth of $5,000); and C, the daughter, will exclude $1,500 ($3,000/$10,000, or three-tenths, of $5,000).

(d) *Nonforfeitable rights.* (1) Except as provided in subparagraphs (3) and (4) of this paragraph, the exclusion provided by section 101(b) does not apply to amounts with respect to which the deceased employee pos-

sessed, immediately before his death, a nonforfeitable right to receive the amounts while living. Section 101(b)(2)(B). For the purpose of section 101(b) and this paragraph, an employee shall be considered to have had a nonforfeitable right with respect to—

(i) Any amount to which he would have been entitled—

(*a*) If he had made an appropriate election or demand, or

(*b*) Upon termination of his employment (see examples (5) and (6) of subparagraph (2) of this paragraph); or

(ii) The present value (immediately before his death) of—

(*a*) Amounts payable as an annuity (as defined in paragraph (b) of § 1.72-2, whether immediate or deferred) by or on behalf of the employer (see example (1) of subparagraph (2) of this paragraph), or

(*b*) Amounts which would have been so payable if the employee had terminated his employment and continued to live;

or

(iii) Any amount to the extent it is paid in lieu of amounts described in either subdivision (i) or (ii) of this subparagraph. See examples (2), (3), and (4) of subparagraph (2) of this paragraph.

For purposes of subdivision (iii) of this subparagraph, any amount paid in discharge of an obligation which arose solely because of the existence of a particular fact or circumstance subsequent to the employee's death shall not be considered an amount paid in lieu of amounts described in subdivision (i) or (ii) of this subparagraph. Subdivision (iii) of this subparagraph shall apply, however, to the extent indicated therein, to amounts payable without regard to any such contingency (to the extent that such amounts are equal to or less than those described in subdivision (i) and (ii) of this subparagraph which are not paid). See paragraph (e)(1)(iii)(*b*) of this section for rules with respect to finding the present value of an annuity immediately before the employee's death.

(2) The application of paragraph (d)(1) of this section may be illustrated by the following examples, in which it is assumed that the plans are not "qualified plans" and that no employer is an organization referred to in section 170(b)(1)(A) (ii) or (vi) or a religious organization (other than a trust) which is exempt from tax under section 501(a):

Example (1). A, who was a participant under the X Company pension plan, retired on December 31, 1953. He had made no contributions to the plan. Upon his retirement, he became entitled to monthly payments of $100 payable for life, or 120 months certain. A died on October 31, 1954, having received 10 monthly payments of $100 each. After his death, the monthly payments became payable to his estate for the remaining 110 months certain. No exclusion from gross income is allowed to A's estate (or any beneficiary who receives the right to such payments from the estate), since the employee's right to the monthly payments was nonforfeitable at the date of his death. It will be noted that in this example it is unnecessary to consider the present value of the annuity to A just before his death since the payments to be made include only those certain to be made in any event under the plan whether or not A continued to live.

Example (2). C, a participant under the Y Company pension plan, died on December 15, 1954, while actively in the employment of the company, survived by a widow and minor children. Because of his years of service, he would have been entitled to an annuity for life, his own contributions to the plan and interest thereon being guaranteed, if he had retired or terminated his employment at a time immediately before his death. The plan further provides that—(a) if, but only if, an employee is survived by a widow and minor children, his widow is to receive an annuity for her life without regard to whether or not the employee had begun his annuity; (b) any payments made with respect to his widow's annuity are to reduce the guaranteed amount to an equal extent; and (c) if the employee is not so survived, the guaranteed amount is payable to his beneficiary or estate, but no amount is payable to anyone with respect to what would have been the widow's annuity. In view of these provisions, that portion of the present value of the annuity payable to C's widow which exceeds the guaranteed amount shall be considered paid neither as an amount, nor in lieu of an amount, which C had a nonforfeitable right to receive while living. The reason for this result is that the payment of such excess is contingent upon C's being survived by a widow and minor children, a circumstance existing subsequent to his death. Conversely, to the

extent that the present value of the annuity payable to C's widow does not exceed the guaranteed amount, annuity payments attributable to such present value shall be considered paid in lieu of an amount which C had a nonforfeitable right to receive while living.

Example (3). D, a participant under the Y Company pension plan, died on January 1, 1955, while actively in the employment of the company. The Y Company plan provides that where an employee dies in service, the present value of the accumulated credits which he could have obtained at that time if he had instead separated from the service shall be paid in a single sum to his surviving spouse or to his estate if no widow survives him. The present value of D's accumulated credits, at the time of his death, was $10,000. However, the plan also provides that a surviving spouse may elect to take, in lieu of a single sum, an annuity the present value of which exceeds such sum by $2,500. D's widow elects to receive an annuity (the present value of which is $12,500). Therefore, $2,500 is an amount to which the exclusion of section 101(b) and this section shall apply.

Example (4). A, an employee of the X Company, continues to work after reaching the normal retirement age of 60 years, although he could have retired at that age and obtained an annuity of $3,000 per year for his life. A is not entitled to any part of the annuity while he is employed and receiving compensation. A dies at the age of 67 while still in active employment. Since he had passed normal retirement age, his additional years of service did not entitle him to a larger annuity at age 67 than that which he could have obtained at age 60. However, the plan of the X Company provides that in the event of an employee's death prior to separation from the service, his widow is to be paid an annuity for her life in the same amount per year as that which the employee could have obtained if he had instead retired; but if no widow survives him, the present value of the annuity which the employee could have obtained at a time just before his death is to be paid to a named beneficiary or the estate of the employee. Assuming that the present value of the annuity to A's widow, whose age is 61, is $36,000 and the present value of the annuity which would have been payable to A at age 67 if he had then retired is $23,500, the present value of the widow's annuity, to the extent of $23,500, is an amount which is payable in lieu of amounts which the employee had a nonforfeitable right to receive while living because it does not exceed the value of his nonforfeitable rights and is not otherwise paid. On the other hand, the $12,500 excess of the value of the widow's annuity ($36,000) over the value of the employee's annuity ($23,500) is an amount to which section 101(b) applies since the employee had no right to any part of it. If no other death benefits are payable, a $5,000 exclusion is available (see section 101(b)(2)(D) and paragraph (e) of this section).

Example (5). The trustee of the X Corporation noncontributory profit-sharing plan is required under the provisions of the plan to pay to the beneficiary of B, an employee of the X Corporation who died on July 1, 1955, the benefit due on account of the death of B. The provisions of the profit-sharing plan give each participating employee in case of termination of employment a 10-percent vested interest in the amount accumulated in his account for each year of participation in the plan. In case of death, the entire credit in the participant's account is to be paid to his beneficiary. At the time of B's death, he had been a participant for three years and the accumulation in his account was $8,000. After his death this amount is paid to his beneficiary. At the time of B's death, the amount distributable to him on account of termination of employment would have been $2,400 (30 percent of $8,000). The difference of $5,600 ($8,000 minus $2,400), payable to the beneficiary of B, is an amount payable solely by reason of B's death. Accordingly, $5,000 of the $5,600 may be excluded from the gross income of the beneficiary receiving such payment (assuming no other death benefits are involved). However, if it is assumed that the facts are the same as above, except that at the time of his death B has been a participant for 6 years, the amount distributable to him on account of termination of employment would have been $4,800 (60 percent of $8,000). The difference of $3,200 ($8,000 minus $4,800), payable to B's beneficiary, is an amount payable solely by reason of B's death. Accordingly, only $3,200 may be excluded from the gross income of the beneficiary receiving such payment (assuming no other death benefits are involved).

Example (6). The X Corporation instituted a trust, forming part of a pension plan, for its employees, the cost thereof being borne entirely by the corporation. The plan provides, in part, that after 10 or more years of service and attaining the age of 55, an employee can elect to retire and receive benefits before the normal retirement date contingent upon the employer's approval. If he retires without the employer's consent, or voluntarily leaves the company, no benefits are or will be payable. The plan further provides that if the employee is involuntarily separated or dies before retirement, he or his beneficiary, respectively, will receive a percentage of the reserve provided for the employee in the trust fund on the following basis: 10 to 15 years of service, 25 percent; 15 to 20 years of service, 50 percent; 20 to 25 years of service, 75 percent; 25 or more

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years of service, 100 percent. A, an employee of the X Corporation for 17 years, died at the age of 56 while in the employ of the corporation. At the time of his death, $15,000 was the reserve provided for him in the trust. His beneficiary receives $7,500, an amount equal to 50 percent of the reserve provided for A's retirement; accordingly, $5,000 of the $7,500 may be excluded from the gross income of the beneficiary receiving such payment (assuming no other death benefits are involved) since A, prior to his death, had only a forfeitable right to receive $7,500.

(3)(i) Notwithstanding the rule stated in subparagraph (1) of this paragraph and illustrated in subparagraph (2) of this paragraph, the exclusion from gross income provided by section 101(b) applies to the receipt of certain amounts, paid under "qualified" plans, with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living (see section 101(b)(2)(B) (i) and (ii)). The payments to which this exclusion applies are—

(*a*) "Total distributions payable" by a stock bonus, pension, or profit-sharing trust described in section 401(a) which is exempt from tax under section 501(a), and

(*b*) "Total amounts" paid under an annuity contract under a plan described in section 403(a), provided such distributions or amounts are paid in full within one taxable year of the distributee (see example (3) of subdivision (ii) of this subparagraph). For the purposes of applying section 101(b), "Total distributions payable" means the balance to the credit of an employee which becomes payable to a distributee on account of the employee's death, either before or after separation from the service (see section 402(a)(3)(C), the regulations thereunder, and examples (2) and (4) of subdivision (ii) of this subparagraph); and "total amounts" means the balance to the credit of an employee which becomes payable to the payee by reason of the employee's death, either before or after separation from the service (see section 403(a)(2)(B), the regulations thereunder, and example (1) of subdivision (ii) of this subparagraph). See subparagraph (4) of this paragraph relating to the exclusion of amounts which are received under annuity contracts purchased by certain exempt organizations and with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living.

(ii) The application of the provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). The widow of an employee elects, under a noncontributory "qualified" plan, to receive in a lump sum the present value of the annuity which C, the deceased employee, could have obtained at a time just before his death if he had retired at that time. Such present value is $6,000. Of this amount, $5,000 is excludable from the widow's gross income despite the fact that C had a nonforfeitable right to the amount in lieu of which the payment is made, since such payment is an amount to which subdivision (i) of this subparagraph applies (assuming no other death benefits are involved).

Example (2). The trustee of the X Corporation noncontributory, "qualified", profit-sharing plan is required under the provisions of the plan to pay to the beneficiary of B, an employee of the X Corporation who died on July 1, 1955, the benefit due on account of the death of B. The provisions of the profit-sharing plan give each participating employee, in case of termination of employment, a 10 percent vested interest in the amount accumulated in his account for each year of participation in the plan, but, in case of death, the entire credit to the participant's account is to be paid to his beneficiary. At the time of B's death, he had been a participant for five years. The accumulation in his account was $8,000, and the amount which would have been distributable to him in the event of termination of employment was $4,000 (50 percent of $8,000). After his death, $8,000 is paid to his beneficiary in a lump sum. (It may be noted that these are the same facts as in example (5) of subparagraph (2) of this paragraph except that the employee has been a participant for five years instead of three and the plan is a "qualified" plan.) It is immaterial that the employee had a nonforfeitable right to $4,000, because the payment of the $8,000 to the beneficiary is the payment of the "total distributions payable" within one taxable year of the distributee to which subdivision (i) of this subparagraph applies. Assuming no other death benefits are involved, the beneficiary may exclude $5,000 of the $8,000 payment from gross income.

Example (3). The facts are the same as in example (2) except that the beneficiary is

entitled to receive only the $4,000 to which the employee had a nonforfeitable right and elects, 30 days after B's death, to receive it over a period of ten years. Since the "total distributions payable" are not paid within one taxable year of the distributee, no exclusion from gross income is allowable with respect to the $4,000.

Example (4). The X Corporation instituted a trust, forming part of a "qualified" profit-sharing plan for its employees, the cost thereof being borne entirely by the corporation. The plan provides, in part, that if, after 10 or more years of service, an employee leaves the employ of the corporation, either voluntarily or involuntarily, before retirement, a percentage of the reserve provided for the employee in the trust fund will be paid to the employee as follows: 10 to 15 years of service, 25 percent; 15 to 20 years of service, 50 percent; 20 to 25 years of service, 75 percent; 25 or more years of service, 100 percent. The plan further provides that if an employee dies before reaching retirement age, his beneficiary will receive a percentage of the reserve provided for the employee in the trust fund, on the same basis as shown in the preceding sentence. A, an employee of the X Corporation for 17 years, died before attaining retirement age while in the employ of the corporation. At the time of his death, $15,000 was the reserve provided for him in the trust fund. His beneficiary receives $7,500 in a lump sum, an amount equal to 50 percent of the reserve provided for A's retirement. The beneficiary may exclude from gross income (assuming no other death benefits are involved) $5,000 of the $7,500, since the latter amount constitutes "total distributions payable" paid within one taxable year of the distributee, to which subdivision (i) of this subparagraph applies.

(4) (i) Notwithstanding the rule stated in subparagraph (1) of this paragraph and illustrated in subparagraph (2) of this paragraph, the exclusion from gross income under section 101(b) also applies (but only to the extent provided in the next sentence) to amounts with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living—

(*a*) If such amounts are paid under an annuity contract purchased by an employer which is an organization referred to in section 170(b)(1)(A) (ii) or (vi) or which is a religious organization (other than a trust) and which is exempt from tax under section 501(a).

(*b*) If such amounts are paid as part of a "total payment" with respect to the deceased employee; and

(*c*) If such "total payment" is paid in full within one taxable year of the payee beginning after December 31, 1957.

However, the amount that is excludable under section 101(b) by reason of this subparagraph shall not exceed an amount which bears the same ratio to the amount which would be includible in the payee's gross income if it were not for the second sentence of section 101(b)(2)(B) and this subparagraph, as the amount contributed by the employer for the annuity contract that was excludable from the deceased employee's gross income under paragraph (b) of § 1.403(b)-1 bears to the total amount contributed by the employer for the annuity contract. See section 101(b)(2)(B)(iii). For purposes of this subparagraph, a "total payment" means a payment of the balance to the credit of an employee with respect to all "section 403(b) annuities" purchased by the employer which becomes payable to the payee by reason of the employee's death, either before or after separation from the service. An annuity contract will be regarded as a "section 403(b) annuity" if any amount contributed (or considered as contributed under paragraph (b)(2) of § 1.403(b)-1) by the employer for such contract was excludable from the employee's gross income under paragraph (b) of § 1.403(b)-1. Under this definition, therefore, an annuity contract may be regarded as a "section 403(b) annuity" even though some of the employer's contributions for the contract were not excludable from the employee's gross income under paragraph (b) of § 1.403(b)-1 because, for example, the employer was not an exempt organization when such contributions were paid. For purposes of computing the ratio described in this subdivision in such a case, the total amount contributed by the employer for the contract includes the amounts contributed by the employer when it was not an exempt organization.

(ii) This subparagraph does not relate to any amounts with respect to which the deceased employee did not

possess, immediately before his death, a nonforfeitable right to receive the amounts while living. Such amounts are excludable under the provisions of section 101(b) without regard to section 101(b)(2)(B) and this subparagraph. Thus, if a "total payment" received by a beneficiary of a deceased employee under an annuity contract purchased by an organization described in subdivision (i)(*a*) of this subparagraph consists both of amounts with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living and of amounts with respect to which the deceased employee did not possess such a nonforfeitable right, only those amounts with respect to which the deceased employee possessed such a nonforfeitable right are amounts to which this subparagraph applies. Therefore, for purposes of computing the ratio described in subdivision (i) of this subparagraph in such a case, there shall be taken into account only the employer contributions attributable to those amounts with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living. See example (3) of subdivision (v) of this subparagraph. In no event, however, may the total amount excludable under section 101(b) with respect to any employee exceed $5,000 (See paragraph (a)(3) of this section).

(iii)(*a*) In any case when the deceased employee's interest in the employer's contributions for an annuity contract was forfeitable at the time the contributions were made but, at a subsequent date prior to his death, such interest changed to a nonforfeitable interest, then, for purposes of computing the ratio described in subdivision (i) of this subparagraph, the cash surrender value of the contract on the date of the change (except to the extent attributable to employee contributions) shall be considered as the amount contributed by the employer for the contract. In such a case, if only part of the deceased employee's interest in the annuity changed from a forfeitable to a nonforfeitable interest, then only the corresponding part of the cash surrender value of the contract on the date of the change shall be considered as the amount contributed by the employer for the contract. Similarly, if part of the deceased employee's interest in the annuity contract changed from a forfeitable to a nonforfeitable interest on a particular date and another part of his interest so changed on a subsequent date, it is necessary, in order to compute the amount contributed by the employer for the contract, to first determine (under the rules in the preceding sentence) the amount that is considered as the amount contributed by the employer with respect to each change, and then to add these amounts together. For purposes of computing the ratio described in subdivision (i) of this subparagraph in all of the above cases, the amount contributed by the employer that was excludable from the employee's gross income under paragraph (b) of § 1.403(b)-1 is that amount which, under paragraph (b)(2) of such section, was considered as employer contributions and which, under such paragraph (b) of § 1.403(b)-1, was excludable from the deceased employee's gross income for the taxable year in which the change occurred.

(*b*) This subdivision (iii) may be illustrated by the following examples:

Example (1). X Organization contributed $4,000 toward the purchase of an annuity contract for A, an employee who died in 1970. At the time they were made, A's interest in such contributions was forfeitable. A made no contributions toward the purchase of the annuity contract. On January 1, 1960, A's entire interest in the annuity contract changed to a nonforfeitable interest. At the time of such change, the cash surrender value of the contract was $5,000. For purposes of the ratio described in subdivision (i) of this subparagraph, the total amount contributed by X Organization for the annuity contract is $5,000. If any part of such $5,000 was excludable under paragraph (b) of § 1.403(b)-1 from A's gross income for his taxable year in which the change occurred, the amount so excludable shall be considered as the amount contributed for the contract by the employer that was excludable from the employee's gross income under paragraph (b) of § 1.403(b)-1.

Example (2). Assume the same facts as in example (1) except that only one-half of A's interest in the annuity contract changed to a nonforfeitable interest on January 1, 1960,

and that no other part of his interest so changed during his lifetime. For purposes of the ratio described in subdivision (i) of this subparagraph, the total amount contributed by X Organization for the annuity contract is $2,500 (½ of the cash surrender value of the annuity contract on the date of the change). To the extent such $2,500 was, under paragraph (b) of § 1.403(b)-1, excludable from A's gross income for the taxable year of the change, it is considered as the amount contributed by the employer that was excludable under paragraph (b) of § 1.403(b)-1.

Example (3). Assume the same facts as in example (1) except that one-half of A's interest in the annuity contract changed to a nonforfeitable interest on January 1, 1960, and the other half of his interest changed to a nonforfeitable interest on January 1, 1965. On January 1, 1965, the cash surrender value of the annuity contract was $6,000. For purposes of the ratio described in subdivision (i) of this subparagraph, the total amount contributed by X organization for the annuity contract is $5,500 (*i.e.*, ½ × $5,000 plus ½ × $6,000). The amount contributed by the employer that was excludable from A's gross income under paragraph (b) of § 1.403(b)-1 is an amount equal to the sum of the amount that was, under such paragraph, excludable from A's gross income for the taxable year during which the first change occurred and the amount that was, under such paragraph, excludable from A's gross income for the taxable year in which the second change occurred.

(iv) For purposes of this subparagraph, an annuity contract will be considered to have been purchased by an employer which is an organization referred to in section 170(b)(1)(A) (ii) or (vi) or which is a religious organization (other than a trust) and which is exempt from tax under section 501(a), if any of the contributions paid toward the purchase price of such contract by the employer were paid at a time when the employer was such an organization. Thus an annuity contract may be regarded as purchased by such an organization even though part of the organization's contributions for such annuity contract were paid at a time when the organization was not such an exempt organization.

(v) The application of this subparagraph may be illustrated by the following examples:

Example (1). The widow of A, a deceased employee, elects, under an annuity contract purchased for A by X Organization, to receive in a lump sum the present value of such annuity contract as of the date of A's death. Such present value is $6,000 and is received by the widow in a taxable year beginning after December 31, 1957. X Organization contributed $3,000 toward the purchase of the annuity contract and A contributed $2,000 toward such purchase. A's interest in X Organization's contributions was nonforfeitable at the time such contributions were made. Thus, just before his death, A's entire interest in the annuity contract was a nonforfeitable interest and, if he had retired at that time, he could have received the present value of $6,000. The whole amount of the $3,000 contributed by X Organization for the annuity contract was excludable from A's gross income under paragraph (b) of § 1.403(b)-1. This annuity contract was the only annuity contract purchased by X Organization for A and was not purchased as part of a qualified plan. However, all the contributions paid by X Organization were paid at a time when X Organization was an organization referred to in section 170(b)(1)(A)(ii) and exempt from tax under section 501(a). The amount that A's widow may exclude from gross income (assuming no other death benefits) is computed in the following manner:

(*a*) Amount includible in gross income without regard to second sentence of section 101(b)(2)(B) ($6,000 minus $2,000 contributed for contract by A)	$4,000
(*b*) Total employer contributions for the contract	$3,000
(*c*) Amount of employer contributions for the contract that was excludable under paragraph (b) of § 1.403(b)-1	$3,000
(*d*) Percent of total employer contributions for the contract that were excludable under paragraph (b) of § 1.403(b)-1 ((*c*) ÷ (*b*))	100%
(*e*) Amount to which section 101(b) exclusion applies ((*d*) × (*a*))	$4,000

Example (2). The facts are the same as in example (1) except that only $2,000 of X Organization's contributions for the annuity contract was excludable from A's gross income under paragraph (b) of § 1.403(b)-1 and that the remaining $1,000 was includible in A's gross income for the taxable years during which such amounts were contributed by X Organization. The amount that A's widow may exclude from gross income (assuming no other death benefits) is computed in the following manner:

(*a*) Amount includible in gross income without regard to second sentence of section 101(b)(2)(B) ($6,000 minus $2,000 contributed for contract by A and $1,000 of X Organization's contributions includible in A's gross income)	$3,000
(*b*) Total employer contributions for the contract	$3,000
(*c*) Amount of employer contributions for the contract that was excludable under paragraph (b) of § 1.403(b)-1	$2,000

(*d*) Percent of total employer contributions for the contract that were excludable under paragraph (b) of § 1.403(b)-1 ((*c*) ÷ (*b*))	67%
(*e*) Amount to which section 101(b) exclusion applies ((*d*) × (*a*))	$2,000

Example (3). The widow of B, a deceased employee, elects, under an annuity contract purchased for B by Y Organization, to receive in a lump sum the present value of such annuity contract as of the date of B's death. Such present value is $6,000 and is received by the widow in a taxable year beginning after December 31, 1957. Y Organization contributed $4,000 toward the purchase of the contract; whereas B made no contributions toward the purchase of the contract. This annuity contract was the only annuity contract purchased by Y Organization for B and was not purchased as part of a "qualified" plan. However, all the contributions paid by Y Organization were paid at a time when it was an organization referred to in section 170(b)(1)(A)(ii) and exempt from tax under section 501(a). B's interest in Y Organization's contributions was, at the time they were paid, forfeitable. However, prior to his death, one-half of B's interest in the annuity contract changed from a forfeitable to a nonforfeitable interest. Therefore, just before his death, B could have obtained $3,000 under the annuity contract if he had retired at that time. On the date of the change, the cash surrender value of the annuity contract was $5,000. As a result of the change, $1,500 was, under paragraph (b) of § 1.403(b)-1, excludable from B's gross income, and $600 was includible in his gross income for the taxable year in which the change occurred. Part of the value of the annuity contract on the date of the change was attributable to contributions made by Y Organization prior to January 1, 1958, and, consequently, was neither excludable from B's gross income under paragraph (b) of § 1.403(b)-1 nor includible in B's gross income (see paragraph (b) of § 1.403(d)-1). The amount that B's widow may exclude from gross income (assuming no other death benefits) is computed in the following manner:

(*a*) Amount of "total payment" with respect to which A had a forfeitable right at time of death (½ × $6,000)	$3,000
(*b*) Amount includible in gross income without regard to second sentence of section 101(b)(2)(B) (½ × $6,000 less $600 includible in B's gross income for year when his rights changed to nonforfeitable rights)	$2,400
(*c*) Total employer contributions for the contract (½ of cash surrender value of contract on date B's rights changed to nonforfeitable rights)	$2,500
(*d*) Amount of employer contributions for the contract that was excludable under paragraph (b) of § 1.403(b)-1	$1,500
(*e*) Percent of total employer contributions for the contract that were excludable under paragraph (b) of § 1.403(b)-1 ((*d*) ÷ (*c*))	60%
(*f*) Amount to which section 101(b) exclusion applies by reason of the second sentence of section 101(b)(2)(B) ((*e*) × (*b*))	$1,440
(*g*) Total amount to which section 101(b) exclusion applies ((*a*) + (*f*))	$4,440

(e) *Annuity payments.* (1) Where death benefits are paid in the form of annuity payments, the following rules shall govern for purposes of the exclusion provided in section 101(b):

(i) The exclusion from gross income provided by section 101(b) does not apply to amounts, paid as an annuity, with respect to which the employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living, or to amounts paid as an annuity in lieu thereof. See paragraph (d) of this section.

(ii) Under section 101(b)(2)(C), no exclusion is allowable for amounts received by a surviving annuitant under a joint and survivor's annuity contract if the annuity starting date (as defined in section 72(c)(4) and paragraph (b) of § 1.72-4) occurs before the death of the employee. If the annuity starting date occurs after the death of the employee, the joint and survivor's annuity contract shall be treated as an annuity to which section 101(b)(2)(D) applies. See subdivision (iii) of this subparagraph.

(iii) (*a*) Subject to the other limitations stated in section 101(b) and in this section (see section 101(b)(2)(D)), the amount to which the exclusion of section 101(b) shall apply, with respect to "amounts received as an annuity" (as defined in paragraph (b) of § 1.72-2) shall be the amount by which the present value of the annuity to be paid to the beneficiary, computed as of the date of the employee's death, exceeds the value (if any) of whichever of the following is the larger:

(*1*) Amounts contributed by the employee (determined in accordance with the provisions of section 72 and the regulations thereunder), or

(*2*) Amounts with respect to which the employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while

living, or amounts paid in lieu thereof (see paragraph (d) of this section).

(*b*) The present value of an annuity (immediately before the death of the employee), to the employee, or (immediately after the death of the employee), to his estate or beneficiary, shall be determined as follows:

(*1*) In the case of an annuity paid by an insurance company or by an organization (other than an insurance company) regularly engaged in issuing annuity contracts with an insurance company as the coinsurer or reinsurer of the obligations under the contract, by use of the discount interest rates and mortality tables used by the insurance company involved to determine the installment benefits;

(*2*) In the case of an annuity paid by an organization (other than an insurance company and other than an organization described in (*1*) of this subdivision) regularly engaged in issuing annuity contracts, by reference to the cost of a comparable contract purchased from an insurance company; and

(*3*) In the case of an annuity to which neither (*1*) nor (*2*) of this subdivision is applicable, by use of the appropriate tables in paragraph (f) of § 20.2031-7 of this chapter (Estate Tax Regulations) as supplemented by "Actuarial Values for Estate and Gift Tax" (Internal Revenue Service Publication No. 11, Rev. 5-59).

(iv) Any amount subject to section 101(b)(2)(D) which is excludable under section 101(b) (see subdivision (iii) of this subparagraph) shall, for purposes of section 72, be treated as additional consideration paid by the employee. See paragraph (b) of § 1.72-8.

(v) Where more than one beneficiary, or more than one death benefit, is involved, the exclusion provided by section 101(b) shall be apportioned to the various beneficiaries and benefits in accordance with the proportion that the present value of each benefit bears to the total present value of all the benefits.

(2) The application of the principles of this paragraph may be illustrated by the following examples:

Example (1). (i) Under the plan of the X Corporation, W, who is the widow of employee A, and who is 55 years old at the time of A's death, is entitled to an immediate annuity of $2,000 per year during her life and C, the minor child of A, is entitled to receive $1,000 per year for 15 years. A made no contributions under the plan and died while still employed by the X Corporation. At the time of A's death, the amount in his account is $18,000. Under the terms of the plan, this amount would have been distributable to him on account of voluntary termination of employment, but would not have been payable after his death except in the form of the annuities just described. This amount, accordingly, constitutes a nonforfeitable interest in lieu of which the annuities are paid. The exclusion does not apply, except to the extent that the present value of the annuities exceeds $18,000, whether or not the plan is "qualified", since the total of the amount in A's account will not be paid within one taxable year of the distributees. See subparagraph (1)(i) of this paragraph.

(ii) The computation of the exclusion applicable to the interests of W and C (assuming that the payments will not be made by an insurance company or some other organization regularly engaged in issuing annuity contracts) is, by application of the tables in paragraph (f) of § 20.2031-7 of this chapter (Estate Tax Regulations), as follows: The present value of W's interest is $26,243.60, determined by multiplying the annual payment of $2,000 by 13.1218 (the factor in Table I for a person aged 55); the present value of C's interest is $11,517.40, determined by multiplying the yearly payment of $1,000 by 11.5174 (the factor in Table II for payments for a term certain of 15 years). The present value of both annuities is $37,761 and (assuming no other death benefits are involved), the total amount excludable is $5,000, because the total present value of the annuities exceeds the employee's nonforfeitable interest by more than $5,000 ($37,761 minus $18,000 equal $19,761). The exclusion allocable to W's interest is $26,243.60/$37,761 times $5,000, or $3,474.96; the exclusion allocable to C's interest is $11,517.40/$37,761 times $5,000, or $1,525.04. That portion of the death benefit exclusion as so determined for each beneficiary is to be treated as consideration paid by the employee for purposes of section 72.

Example (2). The facts are the same as in example (1), except that the nonforfeitable interest of A, at the time of his death, amounted to $33,761. Since the present value of both annuities ($37,761) exceeds the value of such nonforfeitable interest by only $4,000, the latter amount is the total amount excludable from the gross income of the beneficiaries. This $4,000 exclusion is to be divided in the same proportions as those indicated in example (1). Thus, the exclusion allocable to W's interest is $26,243.60/

$37,761 times $4,000, or $2,779.97; and the exclusion allocable to the interest of C is $11,517.40/$37,761 times $4,000, or $1,220.03. That portion of the death benefit exclusion as so determined for each beneficiary is to be treated as consideration paid by the employee for purposes of section 72.

(f) *Distributions on behalf of a self-employed individual.* (1) Under sections 401(c)(1) and 403(a)(3), certain self-employed individuals may be covered by a pension or profit-sharing plan described in section 401(a) and exempt under section 501(a) or under an annuity plan described in section 403(a). However, a payment pursuant to the provisions of any such plan by reason of the death of an individual who participated in such a plan as a self-employed individual immediately before his retirement or death to the beneficiary or estate of such individual does not qualify for the exclusion provided by section 101(b).

(2) The application of this paragraph may be illustrated by the following examples:

Example (1). From 1950 to 1965, A was an employee of B, a sole proprietor. In 1963, B established a qualified pension plan covering A and all other persons who had been employed by B for more than 3 years. In 1965, A acquired from B a 40-percent interest in the capital and profits of the business. A continued to participate in the pension plan as a self-employed individual. In 1970, A died and his widow, in compliance with one of the provisions of the pension plan, elected to receive all of the benefits accrued to A prior to his death in a lump-sum distribution. As A participated in the plan as a self-employed individual immediately prior to his death, A's widow may not exclude any portion of such distribution from her gross income under section 101(b).

Example (2). A, an attorney, is employed by the X Company in their legal department. He is covered by the pension plan that X has established for its employees. Under the terms of A's contract of employment with X, A is permitted to carry on the private practice of law in his off-duty hours. A establishes his own pension plan with respect to his earnings from his private practice. On A's death, his widow elected to receive a lump-sum distribution with respect to any benefits accrued to A under both X's pension plan and A's own pension plan. To the extent that such payment otherwise complies with the requirements of section 101(b), up to $5,000 of the amount paid by X may be excluded from her gross income. No part of the distribution from A's own pension plan may be excluded from her gross income under section 101(b) because A participated in the plan as a self-employed individual immediately before his death.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6722, 29 FR 5070, Apr. 14, 1964; T.D. 6783, 29 FR 18357, Dec. 24, 1964; T.D. 7352, 40 FR 16666, Apr. 14, 1975; T.D. 7428, 41 FR 34619, Aug. 16, 1976]

§ 1.101-3 Interest payments.

(a) *Applicability of section 101(c).* Section 101(c) provides that if any amount excluded from gross income by section 101(a) (relating to life insurance proceeds) or section 101(b) (relating to employees' death benefits) is held under an agreement to pay interest thereon, the interest payments shall be included in gross income. This provision applies to payments made (either by an insurer or by or on behalf of an employer) of interest earned on any amount so excluded from gross income which is held without substantial diminution of the principal amount during the period when such interest payments are being made or credited to the beneficiaries or estate of the insured or the employee. For example, if a monthly payment is $100, of which $99 represents interests and $1 represents diminution of the principal amount, the principal amount shall be considered held under an agreement to pay interest thereon and the interest payment shall be included in the gross income of the recipient. Section 101(c) applies whether the election to have an amount held under an agreement to pay interest thereon is made by the insured or employee or by his beneficiaries or estate, and whether or not an interest rate is explicitly stated in the agreement. Section 101(d), relating to the payment of life insurance proceeds at a date later than death, shall not apply to any amount to which section 101(c) applies. See section 101(d)(4). However, both section 101(c) and section 101(d) may apply to payments received under a single life insurance contract. For provisions relating to the application of this rule to payments received under a permanent life insurance policy with a family income rider attached, see paragraph (h) of § 1.101-4.

(b) *Determination of "present value".* For the purpose of determining whether section 101(c) or section 101(d) applies, the present value (at the time of the insured's death) of any amount which is to be paid at a date later than death shall be determined by the use of the interest rate and mortality tables used by the insurer in determining the size of the payments to be made.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6577, 26 FR 10127, Oct. 28, 1961]

§ 1.101-4 Payment of life insurance proceeds at a date later than death.

(a) *In general.* (1)(i) Section 101(d) states the provisions governing the exclusion from gross income of amounts (other than those to which section 101(c) applies) received under a life insurance contract and paid by reason of the death of the insured which are paid to a beneficiary on a date or dates later than the death of the insured. However, if the amounts payable as proceeds of life insurance to which section 101(a)(1) applies cannot in any event exceed the amount payable at the time of the insured's death, such amounts are fully excludable from the gross income of the recipient (or recipients) without regard to the actual time of payment and no further determination need be made under this section. Section 101(d)(1)(A) provides an exclusion from gross income of any amount determined by a proration, under applicable regulations, of "an amount held by an insurer with respect to any beneficiary". The quoted phrase is defined in section 101(d)(2). For the regulations governing the method of computation of this proration, see paragraphs (c) through (f) of this section. The prorated amounts are to be excluded from the gross income of the beneficiary regardless of the taxable year in which they are actually received (see example (2) of subparagraph (2) of this paragraph).

(ii) Section 101(d)(1)(B) provides an additional exclusion where life insurance proceeds are paid to the surviving spouse of an insured. For purposes of this exclusion, the term "surviving spouse" means the spouse of the insured as of the date of death, including a spouse legally separated, but not under a decree of absolute divorce (section 101(d)(3)). To the extent that the total payments, under one or more agreements, made in excess of the amounts determined by proration under section 101(d)(1)(A) do not exceed $1,000 in the taxable year of receipt, they shall be excluded from the gross income of the surviving spouse (whether or not payment of any part of such amounts is guaranteed by the insurer). Amounts excludable under section 101(d)(1)(B) are not "prorated" amounts.

(2) The principles of this paragraph may be illustrated by the following examples:

Example (1). A surviving spouse elects to receive all of the life insurance proceeds with respect to one insured, amounting to $150,000, in ten annual installments of $16,500 each, based on a certain guaranteed interest rate. The prorated amount is $15,000 ($150,000 ÷ 10). As the second payment, the insurer pays $17,850, which exceeds the guaranteed payment by $1,350 as the result of earnings of the insurer in excess of those required to pay the guaranteed installments. The surviving spouse shall include $1,850 in gross income and exclude $16,000—determined in the following manner:

Fixed payment (including guaranteed interest)	$16,500
Excess interest	1,350
Total payment	17,850
Prorated amount	15,000
Excess over prorated amount	2,850
Annual excess over prorated amount excludable under section 101(d)(1)(B)	1,000
Amount includible in gross income	1,850

Example (2). Assume the same facts as in example (1), except that the third and fourth annual installments, totalling $33,000 (2 · $16,500), are received in a single subsequent taxable year of the surviving spouse. The prorated amount of $15,000 of each annual installment, totalling $30,000, shall be excluded even though the spouse receives more than one annual installment in the single subsequent taxable year. However, the surviving spouse is entitled to only one exclusion of $1,000 under section 101(d)(1)(B) for each taxable year of receipt. The surviving spouse shall include $2,000 in her gross income for the taxable year with respect to the above installment payments ($33,000 less the sum of $30,000 plus $1,000).

Example (3). Assume the same facts as in example (1), except that the surviving spouse dies before receiving all ten annual installments and the remaining installments are paid to her estate or beneficiary. In such a case, $15,000 of each installment would continue to be excludable from the gross income of the recipient, but any amounts received in excess thereof would be fully includible.

(b) *Amount held by an insurer.* (1) For the purpose of the proration referred to in section 101(d)(1), an "amount held by an insurer with respect to any beneficiary" means an amount equal to the present value to such beneficiary (as of the date of death of the insured) of an agreement by the insurer under a life insurance policy (whether as an option or otherwise) to pay such beneficiary an amount or amounts at a date or dates later than the death of the insured (section 101(d)(2)). The present value of such agreement is to be computed as if the agreement under the life insurance policy had been entered into on the date of death of the insured, except that such value shall be determined by the use of the mortality table and interest rate used by the insurer in calculating payments to be made to the beneficiary under such agreement. Where an insurance policy provides an option for the payment of a specific amount upon the death of the insured in full discharge of the contract, such lump sum is the amount held by the insurer with respect to all beneficiaries (or their beneficiaries) under the contract. See, however, paragraph (e) of this section.

(2) In the case of two or more beneficiaries, the "amount held by the insurer" with respect to each beneficiary depends on the relationship of the different benefits payable to such beneficiaries. Where the amounts payable to two or more beneficiaries are independent of each other, the "amount held by the insurer with respect to each beneficiary" shall be determined and prorated over the periods involved independently. Thus, if a certain amount per month is to be paid to A for his life, and, concurrently, another amount per month is to be paid to B for his life, the "amount held by the insurer" shall be determined and prorated for both A and B independently, but the aggregate shall not exceed the total present value of such payments to both. On the other hand, if the obligation to pay B was contingent on his surviving A, the "amount held by the insurer" shall be considered an amount held with respect to both beneficiaries simultaneously. Furthermore, it is immaterial whether B is a named beneficiary or merely the ultimate recipient of payments for a term of years. For the special rules governing the computation of the proration of the "amount held by an insurer" in determining amounts excludable under the provisions of section 101(d), see paragraphs (c) to (f), inclusive, of this section.

(3) Notwithstanding any other provision of this section, if the policy was transferred for a valuable consideration, the total "amount held by an insurer" cannot exceed the sum of the consideration paid plus any premiums or other consideration paid subsequent to the transfer if the provisions of section 101(a)(2) and paragraph (b) of § 1.101-1 limit the excludability of the proceeds to such total.

(c) *Treatment of payments for life to a sole beneficiary.* If the contract provides for the payment of a specified lump sum, but, pursuant to an agreement between the beneficiary and the insurer, payments are to be made during the life of the beneficiary in lieu of such lump sum, the lump sum shall be divided by the life expectancy of the beneficiary determined in accordance with the mortality table used by the insurer in determining the benefits to be paid. However, if payments are to be made to the estate or beneficiary of the primary beneficiary in the event that the primary beneficiary dies before receiving a certain number of payments or a specified total amount, such lump sum shall be reduced by the present value (at the time of the insured's death) of amounts which may be paid by reason of the guarantee, in accordance with the provisions of paragraph (e) of this section, before making this calculation. To the extent that payments received in each taxable year do not exceed the amount found from the above calculation, they are "prorated amounts" of the "amount held by an

insurer" and are excludable from the gross income of the beneficiary without regard to whether he lives beyond the life expectancy used in making the calculation. If the contract in question does not provide for the payment of a specific lump sum upon the death of the insured as one of the alternative methods of payment, the present value (at the time of the death of the insured) of the payments to be made the beneficiary, determined in accordance with the interest rate and mortality table used by the insurer in determining the benefits to be paid, shall be used in the above calculation in lieu of a lump sum.

(d) *Treatment of payments to two or more beneficiaries*—(1) *Unrelated payments.* If payments are to be made to two or more beneficiaries, but the payments to be made to each are to be made without regard to whether or not payments are made or continue to be made to the other beneficiaries, the present value (at the time of the insured's death) of such payments to each beneficiary shall be determined independently for each such beneficiary. The present value so determined shall then be divided by the term for which the payments are to be made. If the payments are to be made for the life of the beneficiary, the divisor shall be the life expectancy of the beneficiary. To the extent that payments received by a beneficiary do not exceed the amount found from the above calculation, they are "prorated amounts" of the "amount held by an insurer" with respect to such beneficiary and are excludable from the gross income of the beneficiary without regard to whether he lives beyond any life expectancy used in making the calculation. For the purpose of the calculation described above, both the "present value" of the payments to be made periodically and the "life expectancy" of the beneficiary shall be determined in accordance with the interest rate and mortality table used by the insurer in determining the benefits to be paid. If payments are to be made to the estate or beneficiary of a primary beneficiary in the event that such beneficiary dies before receiving a certain number of payments or a specified total amount, the "present value" of payments to such beneficiary shall not include the present value (at the time of the insured's death) of amounts which may be paid by reason of such a guarantee. See paragraph (e) of this section.

(2) *Related payments.* If payments to be made to two or more beneficiaries are in the nature of a joint and survivor annuity (as described in paragraph (b) of § 1.72-5), the present value (at the time of the insured's death) of the payments to be made to all such beneficiaries shall be divided by the life expectancy of such beneficiaries as a group. To the extent that the payments received by a beneficiary do not exceed the amount found from the above calculation, they are "prorated amounts" of the "amount held by an insurer" with respect to such beneficiary and are excludable from the gross income of the beneficiary without regard to whether all the beneficiaries involved live beyond the life expectancy used in making the calculation. For the purpose of the calculation described above, both the "present value" of the payments to be made periodically and the "life expectancy" of all the beneficiaries as a group shall be determined in accordance with the interest rate and mortality table used by the insurer in determining the benefits to be paid. If the contract provides that certain payments are to be made in the event that all the beneficiaries of the group die before a specified number of payments or a specified total amount is received by them, the present value of payments to be made to the group shall not include the present value (at the time of the insured's death) of amounts which may be paid by reason of such a guarantee. See paragraph (e) of this section.

(3) *Payments to secondary beneficiaries.* Payments made by reason of the death of a beneficiary (or beneficiaries) under a contract providing that such payments shall be made in the event that the beneficiary (or beneficiaries) die before receiving a specified number of payments or a specified total amount shall be excluded from the gross income of the recipient to the extent that such payments are made solely by reason of such guarantee.

(e) *Treatment of present value of guaranteed payments.* In the case of payments which are to be made for a life or lives under a contract providing that further amounts shall be paid upon the death of the primary beneficiary (or beneficiaries) in the event that such beneficiary (or beneficiaries) die before receiving a specified number of payments or a specified total amount, the present value (at the time of the insured's death) of all payments to be made under the contract shall not include, for purposes of prorating the amount held by the insurer, the present value of the payments which may be made to the estate or beneficiary of the primary beneficiary. In such a case, any lump sum amount used to measure the value of the amount held by an insurer with respect to the primary beneficiary must be reduced by the value at the time of the insured's death of any amounts which may be paid by reason of the guarantee provided for a secondary beneficiary or the estate of the primary beneficiary before prorating such lump sum over the life or lives of the primary beneficiaries. Such present value (of the guaranteed payment) shall be determined by the use of the interest rate and mortality tables used by the insurer in determining the benefits to be paid.

(f) *Treatment of payments not paid periodically.* Payments made to beneficiaries other than periodically shall be included in the gross income of the recipients, but only to the extent that they exceed amounts payable at the time of the death of the insured to each such beneficiary or, where no such amounts are specified, the present value of such payments at that time.

(g) *Examples.* The principles of this section may be illustrated by the following examples:

Example (1). A life insurance policy provides for the payment of $20,000 in a lump sum to the beneficiary at the death of the insured. Upon the death of the insured, the beneficiary elects an option to leave the proceeds with the company for five years and then receive payment of $24,000, having no claim of right to any part of such sum before the entire five years have passed. Upon the payment of the larger sum, $24,000, the beneficiary shall include $4,000 in gross income and exclude $20,000 therefrom. If it is assumed that the same insurer has determined the benefits to be paid, the same result would obtain if no lump sum amount were provided for at the death of the insured and the beneficiary were to be paid $24,000 five years later. In neither of these cases would the surviving spouse be able to exclude any additional amount from gross income since both cases involve an amount held by an insurer under an agreement to pay interest thereon to which section 101(c) applies, rather than an amount to be paid periodically after the death of the insured to which section 101(d) applies.

Example (2). A life insurance policy provides that $1,200 per year shall be paid the sole beneficiary (other than a surviving spouse) until a fund of $20,000 and interest which accrues on the remaining balance is exhausted. A guaranteed rate of interest is specified, but excess interest may be credited according to the earnings of the insurer. Assuming that the fund will be exhausted in 20 years if only the guaranteed interest is actually credited, the beneficiary shall exclude $1,000 of each installment received ($20,000 divided by 20) and any installments received, whether by the beneficiary or his estate or beneficiary, in excess of 20 shall be fully included in the gross income of the recipient. If, instead, the excess interest were to be paid each year, any portion of each installment representing an excess over $1,000 would be fully includible in the recipient's gross income. Thus, if an installment of $1,350 were received, $350 of it would be included in gross income.

Example (3). Assume that the sole life insurance policy of a decedent provides only for the payment of $5,000 per year for the life of his surviving spouse, beginning with the insured's death. If the present value of the proceeds, determined by reference to the interest rate and the mortality table used by the insurance company, is $60,000, and such beneficiary's life expectancy is 20 years, $3,000 of each $5,000 payment ($60,000 divided by 20) is excludable as the prorated portion of the "amount held by an insurer". For each taxable year in which a payment is made, an additional $1,000 is excludable from the gross income of the surviving spouse. Hence, if she receives only one $5,000 payment in her taxable year, only $1,000 is includible in her gross income in that year with respect to such payment ($5,000 less the total amount excludable, $4,000). Assuming that the policy also provides for payments of $2,000 per year for 10 years to the daughter of the insured, the present value of the payments to the daughter is to be computed separately for the purpose of determining the excludable portion of each payment to her. Assuming that such present value is $15,000, $1,500 of each pay-

ment of $2,000 received by the daughter is excludable from her gross income ($15,000 divided by 10). The remaining $500 shall be included in the gross income of the daughter.

Example (4). Beneficiaries A and B, neither of whom is the surviving spouse of the insured, are each to receive annual payments of $1,800 for each of their respective lives upon the death of the insured. The contract does not provide for payments to be made in any other manner. Assuming that the present value of the payments to be made to A, whose life expectancy according to the insurer's mortality table is 30 years, is $36,000, A shall exclude $1,200 of each payment received ($36,000 divided by 30). Assuming that the present value of the payments to be made to B, whose life expectancy according to the insurer's mortality table is 20 years, is $27,000, B shall exclude $1,350 of each payment received ($27,000 divided by 20).

Example (5). A life insurance policy provides for the payment of $76,500 in a lump sum to the beneficiary, A, at the death of the insured. Upon the insured's death, however, A selects an option for the payment of $2,000 per year for her life and for the same amount to be paid after her death to B, her daughter, for her life. Assuming that since A is 51 years of age and her daughter is 28 years of age, the insurer determined the amount of the payments by reference to a mortality table under which the life expectancy for the lives of both A and B, joint and survivor, is 51 years, $1,500 of each $2,000 payment to either A or B ($76,500 divided by 51, or $1,500) shall be excluded from the gross income of the recipient. However, if A is the surviving spouse of the insured and no other contracts of insurance whose proceeds are to be paid to her at a date later than death are involved, A shall exclude the entire payment of $2,000 in any taxable year in which she receives but one such payment because of the additional exclusion under section 101(d)(1)(B).

Example (6). Beneficiaries A and B, neither of whom is the surviving spouse of the insured, are each to receive annual payments of $1,800 for each of their respective lives upon the death of the insured, but after the death of either, the survivor is to receive the payments formerly made to the deceased beneficiary until the survivor dies. Assuming that the life expectancy, joint and survivor, of A and B in accordance with the mortality table used by the insurer is 32 years and assuming that the total present value of the benefits to both (determined in accordance with the interest rate used by the insurer) is $80,000, A and B shall each exclude $1,250 of each installment of $1,800 ($80,000 divided by the life expectancy, 32, multiplied by the fraction of the annual payment payable to each, one-half) until the death of either. Thereafter, the survivor shall exclude $2,500 of each installment of $3,600 ($80,000 divided by 32).

Example (7). A life insurance policy provides for the payment of $75,000 in a lump sum to the beneficiary, A, at the death of the insured. A, upon the insured's death, however, selects an option for the payment of $4,000 per year for life, with a guarantee that any part of the $75,000 lump sum not paid to A before his death shall be paid to B (or his estate), A's beneficiary. Assuming that, under the criteria used by the insurer in determining the benefits to be paid, the present value of the guaranteed amount to B is $13,500 and that A's life expectancy is 25 years, the lump sum shall be reduced by the present value of the guarantee to B ($75,000 less $13,500, or $61,500) and divided by A's life expectancy ($61,500 divided by 25, or $2,460). Hence, $2,460 of each $4,000 payment is excludable from A's gross income. If A is the surviving spouse of the insured and no other contracts of insurance whose proceeds are to be paid to her at a date later than death are involved, A shall exclude $3,460 of each $4,000 payment from gross income in any taxable year in which but one such payment is received. Under these facts, if any amount is paid to B by reason of the fact that A dies before receiving a total of $75,000, the residue of the lump sum paid to B shall be excluded from B's gross income since it is wholly in lieu of the present value of such guarantee plus the present value of the payments to be made to the first beneficiary, and is therefore entirely an "amount held by an insurer" paid at a date later than death (see paragraph (d)(3) of this section).

Example (8). Assume that an insurance policy does not provide for the payment of a lump sum, but provides for the payment of $1,200 per year for a beneficiary's life upon the death of the insured, and also provides that if ten payments are not made to the beneficiary before death a secondary beneficiary (whether named by the insured or by the first beneficiary) shall receive the remainder of the ten payments in similar installments. If, according to the criteria used by the insurance company in determining the benefits, the present value of the payments to the first beneficiary is $12,000 and the life expectancy of such beneficiary is 15 years, $800 of each payment received by the first beneficiary is excludable from gross income. Assuming that the same figures obtain even though the payments are to be made at the rate of $100 per month, the yearly exclusion remains the same unless more or less than twelve months' installments are received by the beneficiary in a particular taxable year. In such a case two-thirds of the total received in the particular taxable year with respect to such benefici-

ary shall be excluded from gross income. Under either of the above alternatives, any amount received by the second beneficiary by reason of the guarantee of ten payments is fully excludable from the beneficiary's gross income since it is wholly in lieu of the present value of such guarantee plus the present value of the payments to be made to the first beneficiary and is therefore entirely an "amount held by an insurer" paid at a date later than death (see paragraph (d)(3) of this section).

(h) *Applicability of both section 101(c) and 101(d) to payments under a single life insurance contract*—(1) *In general.* Section 101(d) shall not apply to interest payments on any amount held by an insurer under an agreement to pay interest thereon (see sections 101(c) and 101(d)(4) and § 1.101-3). On the other hand, both section 101(c) and section 101(d) may be applicable to payments received under a single life insurance contract, if such payments consist both of interest on an amount held by an insurer under an agreement to pay interest thereon and of amounts held by the insurer and paid on a date or dates later than the death of the insured. One instance when both section 101(c) and section 101(d) may be applicable to payments received under a single life insurance contract is in the case of a permanent life insurance policy with a family income rider attached. A typical family income rider is one which provides additional term insurance coverage for a specified number of years from the register date of the basic policy. Under the policy with such a rider, if the insured dies at any time during the term period, the beneficiary is entitled to receive (i) monthly payments of a specified amount commencing as of the date of death and continuing for the balance of the term period, and (ii) a lump sum payment of the proceeds under the basic policy to be paid at the end of the term period. If the insured dies after the expiration of the term period, the beneficiary receives only the proceeds under the basic policy. If the insured dies before the expiration of the term period, part of each monthly payment received by the beneficiary during the term period consists of interest on the proceeds of the basic policy (such proceeds being retained by the insurer until the end of the term period). The remaining part consists of an installment (principal plus interest) of the proceeds of the terms insurance purchased under the family income rider. The amount of term insurance which is provided under the family income rider is, therefore, that amount which, at the date of the insured's death, will provide proceeds sufficient to fund such remaining part of each monthly payment. Since the proceeds under the basic policy are held by the insurer until the end of the term period, that portion of each monthly payment which consists of interest on such proceeds is interest on an amount held by an insurer under an agreement to pay interest thereon and is includible in gross income under section 101(c). On the other hand, since the remaining portion of each monthly payment consists of an installment payment (principal plus interest) of the proceeds of the term insurance, it is a payment of an amount held by the insurer and paid on a date later than the death of the insured to which section 101(d) and this section applies (including the $1,000 exclusion allowed the surviving spouse under section 101(d)(1)(B)). The proceeds of the basic policy, when received in a lump sum at the end of the term period, are excludable from gross income under section 101(a).

(2) *Example of tax treatment of amounts received under a family income rider.* The following example illustrates the application of the principles contained in subparagraph (1) of this paragraph to payments received under a permanent life insurance policy with a family income rider attached:

Example. The sole life insurance policy of the insured provides for the payment of $100,000 to the beneficiary (the insured's spouse) on his death. In addition, there is attached to the policy a family income rider which provides that, if the insured dies before the 20th anniversary of the basic policy, the beneficiary shall receive (i) monthly payments of $1,000 commencing on the date of the insured's death and ending with the payment prior to the 20th anniversary of the basic policy, and (ii) a single payment of $100,000 payable on the 20th anniversary of the basic policy. On the date of the insured's death, the beneficiary (surviving spouse of the insured) is entitled to 36

monthly payments of $1,000 and to the single payment of $100,000 on the 20th anniversary of the basic policy. The value of the proceeds of the term insurance at the date of the insured's death is $28,409.00 (the present value of the portion of the monthly payments to which section 101(d) applies computed on the basis that the interest rate used by the insurer in determining the benefits to be paid under the contract is 2¼ percent). The amount of each monthly payment of $1,000 which is includible in the beneficiary's gross income is determined in the following manner:

(*a*) Total amount of monthly payment	$1,000.00
(*b*) Amount includible in gross income under section 101(c) as interest on the $100,000 proceeds under the basic policy held by the insurer until 20th anniversary of the basic policy (computed on the basis that the interest rate used by the insurer in determining the benefits to be paid under the contract is 2¼ percent)	185.00
(*c*) Amount to which section 101(d) applies ((a) minus (b))	815.00
(*d*) Amount excludable from gross income under section 101(d) ($28,409÷36)	789.14
(*e*) Amount includible in gross income under section 101(d) without taking into account the $1,000 exclusion allowed the beneficiary as the surviving spouse ((c) minus (d))	25.86

The beneficiary, as the surviving spouse of the insured, is entitled to exclude the amounts otherwise includible in gross income under section 101(d) (item (*e*)) to the extent such amounts do not exceed $1,000 in the taxable year of receipt. This exclusion is not applicable, however, with respect to the amount of each payment which is includible in gross income under section 101(c) (item (*b*)). In this example, therefore, the beneficiary must include $185 of each monthly payment in gross income (amount includible under section 101(c)), but may exclude the $25.86 which is otherwise includible under section 101(d). The payment of $100,000 which is payable to the beneficiary on the 20th anniversary of the basic policy will be entirely excludable from gross income under section 101(a).

(3) *Limitation on amount considered to be an "amount held by an insurer".* See paragraph (b)(3) of this section for a limitation on the amount which shall be considered an "amount held by an insurer" in the case of proceeds of life insurance which are paid subsequent to the transfer of the policy for a valuable consideration.

(4) *Effective date.* The provisions of this paragraph are applicable only with respect to amounts received during taxable years beginning after October 28, 1961, irrespective of the date of the death of the insured.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6577, 26 FR 10127, Oct. 28, 1961; 26 FR 10275, Nov. 2, 1961]

§ 1.101–5 Alimony, etc., payments.

Proceeds of life insurance policies paid by reason of the death of the insured to his separated wife, or payment excludable as death benefits under section 101(b) paid to a deceased employee's separated wife, if paid to discharge legal obligations imposed by a decree of divorce or separate maintenance, by a written separation agreement executed after August 16, 1954, or by a decree of support entered after March 1, 1954, shall be included in the gross income of the separated wife if section 71 or 682 is applicable to the payments made. For definition of "wife", see section 7701(a)(17) and the regulations thereunder.

§ 1.101–6 Effective date.

(a) Except as otherwise provided in paragraph (h)(4) of § 1.101–4, the provisions of section 101 of the Internal Revenue Code of 1954 and §§ 1.101–1, 1.101–2, 1.101–3, 1.101–4, and 1.101–5 are applicable only with respect to amounts received by reason of the death of an insured or an employee occurring after August 16, 1954. In the case of such amounts, these sections are applicable even though the receipt of such amounts occurred in a taxable year beginning before January 1, 1954, to which the Internal Revenue Code of 1939 applies.

(b) Section 22(b)(1) of the Internal Revenue Code of 1939 and the regulations pertaining thereto shall apply to amounts received by reason of the death of an insured or an employee occurring before August 17, 1954, regardless of the date of receipt.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6577, 26 FR 10128, Oct. 28, 1961]

§ 1.102–1 Gifts and inheritances.

(a) *General rule.* Property received as a gift, or received under a will or under statutes of descent and distribution, is not includible in gross income,

although the income from such property is includible in gross income. An amount of principal paid under a marriage settlement is a gift. However, see section 71 and the regulations thereunder for rules relating to alimony or allowances paid upon divorce or separation. Section 102 does not apply to prizes and awards (see section 74 and § 1.74-1) nor to scholarships and fellowship grants (see section 117 and the regulations thereunder).

(b) *Income from gifts and inheritances.* The income from any property received as a gift, or under a will or statute of descent and distribution shall not be excluded from gross income under paragraph (a) of this section.

(c) *Gifts and inheritances of income.* If the gift, bequest, devise, or inheritance is of income from property, it shall not be excluded from gross income under paragraph (a) of this section. Section 102 provides a special rule for the treatment of certain gifts, bequests, devises, or inheritances which by their terms are to be paid, credited, or distributed at intervals. Except as provided in section 663(a)(1) and paragraph (d) of this section, to the extent any such gift, bequest, devise, or inheritance is paid, credited, or to be distributed out of income from property, it shall be considered a gift, bequest, devise, or inheritance of income from property. Section 102 provides the same treatment for amounts of income from property which is paid, credited, or to be distributed under a gift or bequest whether the gift or bequest is in terms of a right to payments at intervals (regardless of income) or is in terms of a right to income. To the extent the amounts in either case are paid, credited, or to be distributed at intervals out of income, they are not to be excluded under section 102 from the taxpayer's gross income.

(d) *Effect of subchapter J.* Any amount required to be included in the gross income of a beneficiary under sections 652, 662, or 668 shall be treated for purposes of this section as a gift, bequest, devise, or inheritance of income from property. On the other hand, any amount excluded from the gross income of a beneficiary under section 663(a)(1) shall be treated for purposes of this section as property acquired by gift, bequest, devise, or inheritance.

(e) *Income taxed to grantor or assignor.* Section 102 is not intended to tax a donee upon the same income which is taxed to the grantor of a trust or assignor of income under section 61 or sections 671 through 677, inclusive.

§ 1.103-1 Interest upon obligations of a State, territory, etc.

(a) Interest upon obligations of a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof (hereinafter collectively or individually referred to as "State or local governmental unit") is not includable in gross income, except as provided under section 103 (c) and (d) and the regulations thereunder.

(b) Obligations issued by or on behalf of any State or local governmental unit by constituted authorities empowered to issue such obligations are the obligations of such a unit. However, section 103(a)(1) and this section do not apply to industrial development bonds except as otherwise provided in section 103(c). See section 103(c) and §§ 1.103-7 through 1.103-12 for the rules concerning interest paid on industrial development bonds. See section 103(d) for rules concerning interest paid on arbitrage bonds. Certificates issued by a political subdivision for public improvements (such as sewers, sidewalks, streets, etc.) which are evidence of special assessments against specific property, which assessments become a lien against such property and which the political subdivision is required to enforce, are, for purposes of this section, obligations of the political subdivision even though the obligations are to be satisfied out of special funds and not out of general funds or taxes. The term "political subdivision", for purposes of this section denotes any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit. As thus defined, a political subdi-

vision of any State or local governmental unit may or may not, for purposes of this section, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of any such unit.

[T.D. 7199, 37 FR 15486, Aug. 3, 1972]

§ 1.103–2 Dividends from shares and stock of Federal agencies or instrumentalities.

(a) *Issued before March 28, 1942.* (1) Section 26 of the Federal Farm Loan Act of July 17, 1916 (12 U.S.C. 931), provides that Federal land banks and Federal land bank associations, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate. Section 7 of the Federal Reserve Act of December 23, 1913 (12 U.S.C. 531), provides that Federal reserve banks, including the capital stock and surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate. Section 13 of the Federal Home Loan Bank Act (12 U.S.C. 1433) provides that the Federal Home Loan Bank including its franchise, its capital, reserves, and surplus, its advances, and its income shall be exempt from all taxation, except taxes upon real estate. Section 5(h) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(h)) provides that shares of Federal savings and loan associations shall, both as to their value and the income therefrom, be exempt from all taxation (except surtaxes, estate, inheritance, and gift taxes) imposed by the United States. Under the above-mentioned provisions, income consisting of dividends on stock of Federal land banks, Federal land bank associations, Federal home loan banks, and Federal reserve banks is not, in the case of stock issued before March 28, 1942, includable in gross income. Income consisting of dividends on share accounts of Federal savings and loan associations is includable in gross income but, in the case of shares issued before March 28, 1942, is not subject to the normal tax on income. For taxability of such income in the case of such stock or shares issued on or after March 28, 1942, see section 6 of the Public Debt Act of 1942 (31 U.S.C. 742a) and paragraph (b) of this section. For the time at which a stock or share is issued within the meaning of this section, see paragraph (b) of this section.

(2) Regardless of the exemption from income tax of dividends paid on the stock of Federal reserve banks, dividends paid by member banks are treated like dividends of ordinary corporations.

(3) Dividends on the stock of the central bank for cooperatives, the production credit corporations, production credit associations, and banks for cooperatives, organized under the provisions of the Farm Credit Act of 1933 (12 U.S.C. 1138), constitute income to the recipients, subject to both the normal tax and surtax (see section 63 of the Farm Credit Act of 1933 (12 U.S.C. 1138c)).

(b) *Issued on or after March 28, 1942.* (1) By virtue of the provisions of section 6 of the Public Debt Act of 1942 (31 U.S.C. 742a), the tax exemption provisions set forth in paragraph (a) of this section with respect to income consisting of dividends on stock of the Federal land banks, Federal land bank associations, and Federal reserve banks, or on share accounts of Federal savings and loan associations, are not applicable in the case of dividends on such stock or shares issued on or after March 28, 1942.

(2) For the purposes of this section, a stock or share is deemed to be issued at the time and to the extent that payment therefor is made to the agency or instrumentality. The date of issuance of the certificate or other evidence of ownership of such stock or share is not determinative if payment is made at an earlier or later date. Where old stock is retired in exchange for new stock of a different character or preference, the new stock shall be deemed to have been issued at the time of the exchange rather than when the old stock was paid for. These rules may be illustrated by the following examples:

Example (1). A, the owner of an investment share account, consisting of 10 shares,

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in a Federal savings and loan association, has a single certificate issued before March 28, 1942, evidencing such ownership. In order that A may dispose of half of such shares, the association at his request issues, after March 27, 1942, two 5-share certificates in substitution for the 10-share certificate. The shares evidenced by the two new certificates are deemed to have been issued before March 28, 1942, the shares having been paid for before such date.

Example (2). The X Bank, a member of a Federal reserve bank, owns 50 shares of Federal reserve bank stock, evidenced by a single stock certificate issued before March 28, 1942. On December 31, 1942, the X Bank reduces the amount of its capital stock, as a result of which it is required to reduce the amount of its Federal reserve bank stock to 40 shares. It surrenders the 50-share certificate to the Federal reserve bank and receives a new 40-share certificate. The 40 shares evidenced by such certificate are deemed to have been issued before March 28, 1942. On December 31, 1943, the X Bank increases the amount of its capital stock, as a result of which it is required to purchase 10 additional shares of the Federal reserve bank stock. The Federal reserve bank issues a 10-share certificate evidencing ownership of the new shares. Of the 50 shares then owned by the X Bank, 40 were issued prior to March 28, 1942, and 10 were issued after March 27, 1942.

Example (3). A, the owner of a savings share account in the amount of $100 in a Federal savings and loan association, has a passbook containing a certificate issued prior to March 28, 1942, evidencing such ownership. Subsequent to March 27, 1942, A deposits $10,000 in the account. With respect to the $10,000 deposit, the share is deemed to have been issued after March 27, 1942.

§ 1.103-3 Interest upon notes secured by mortgages executed to Federal agencies or instrumentalities.

Section 26 of the Federal Farm Loan Act (12 U.S.C. 931), and section 210 of such act, as added by section 2 of the act of March 4, 1923 (12 U.S.C. 1111), provide that first mortgages executed to Federal land banks, joint-stock land banks, or Federal intermediate credit banks, and the income derived therefrom, shall be exempt from taxation. Accordingly, income consisting of interest on promissory notes held by such banks and secured by such first mortgages is not subject to the income tax.

§ 1.103-4 Interest upon United States obligations.

(a) *Issued before March 1, 1941.* (1) Interest upon obligations of the United States issued on or before September 1, 1917, is exempt from tax. In the case of obligations issued by the United States after September 1, 1917, and in the case of obligations of a corporation organized under act of Congress, if such corporation is an instrumentality of the United States, the interest is exempt from tax only if and to the extent provided in the acts authorizing the issue thereof, as amended and supplemented.

(2) Interest on Treasury bonds issued before March 1, 1941, is exempt from Federal income taxes except surtaxes imposed upon the income or profits of individuals, associations, or corporations. However, interest on an aggregate of not exceeding $5,000 principal amount of such bonds is also exempt from surtaxes. Interest in excess of the interest on an aggregate of not exceeding $5,000 principal amount of such bonds is subject to surtax and must be included in gross income.

(3) Interest credited to postal savings accounts upon moneys deposited before March 1, 1941, in postal savings banks is wholly exempt from income tax.

(b) *Issued on or after March 1, 1941.* (1) Under the provisions of sections 4 and 5 of the Public Debt Act of 1941 (31 U.S.C. 742a), interest upon obligations issued on or after March 1, 1941, by the United States, or any agency or instrumentality thereof, shall not have any exemption, as such, from Federal income tax except in respect of any such obligations which the Federal Maritime Board and Maritime Administration (formerly United States Maritime Commission) or the Federal Housing Administration has, before March 1, 1941, contracted to issue at a future date. The interest on such obligations so contracted to be issued shall bear such tax-exemption privileges as were at the time of such contract provided in the law authorizing their issuance. For the purposes hereof, under section 4(a) of the Public Debt Act of 1941, a Territory and a possession of

the United States (or any political subdivisions thereof), and the District of Columbia, and any agency or instrumentality of any one or more of the foregoing, shall not be considered as an agency or instrumentality of the United States.

(2) In the case of obligations issued as the result of a refunding operation, as, for example, where a corporation exchanges bonds for previously issued bonds, the refunding obligations are deemed, for the purposes of this section, to have been issued at the time of the exchange rather than at the time the original bonds were issued.

§ 1.103–5 Treasury bond exemption in the case of trusts or partnerships.

(a) When the income of a trust is taxable to beneficiaries, as in the case of a trust the income of which is to be distributed to the beneficiaries currently, each beneficiary is entitled to exemption as if he owned directly a proportionate part of the Treasury bonds held in trust. When, on the other hand, income is taxable to the trustee, as in the case of a trust the income of which is accumulated for the benefit of unborn or unascertained persons, the trust, as the owner of the bonds held in trust, is entitled to the exemption on account of such ownership. In general, see sections 652(b) and 662(b) and the regulations thereunder.

(b) As the income of a partnership is taxable to the individual partners, each partner is entitled to exemption as if he owned directly a proportionate part of the bonds held by the partnership. For rules relating to partially tax-exempt interest see section 702(a)(7) and the regulations thereunder.

§ 1.103–6 Interest upon United States obligations in the case of nonresident aliens and foreign corporations, not engaged in business in the United States.

By virtue of section 4 of the Victory Liberty Loan Act of March 3, 1919 (31 U.S.C. 750), amending section 3 of the Fourth Liberty Bond Act of July 9, 1918 (31 U.S.C. 750), the interest received on and after March 3, 1919, on bonds, notes, and certificates of indebtedness of the United States while beneficially owned by a nonresident alien individual, or a foreign corporation, partnership, or association, if such individual, corporation, partnership, or association is not engaged in business in the United States, is exempt from income taxes. Such exemption applies only to such bonds, notes, or certificates as have been issued before March 1, 1941. Interest derived by a nonresident alien individual, or by a foreign corporation, partnership, or association on such bonds, notes, or certificates issued on or after March 1, 1941, is subject to tax as in the case of taxpayers generally as provided in paragraph (b) of § 1.103–4.

§ 1.103–7 Industrial development bonds.

(a) *In general.* Under section 103(c)(1) and this section, an industrial development bond issued after April 30, 1968, shall be treated as an obligation not described in section 103(a)(1) and § 1.103–1. Accordingly, interest paid on such a bond is includable in gross income unless the bond was issued by a State, or local governmental unit to finance certain exempt facilities (see section 103(c)(4) and § 1.103–8), to finance an industrial park (see section 103(c)(5) and § 1.103–9), or as part of an exempt small issue (see section 103(c)(6) and § 1.103–10). For applicable rules when an industrial development bond is held by a substantial user (or a person related to a substantial user) of such an exempt facility, or an industrial park, or a facility financed with the proceeds of such an exempt small issue, see section 103(c)(7) and § 1.103–11. See also § 1.103–12 for the transitional provisions concerning the interest paid on certain industrial development bonds issued before January 1, 1969, and certain other industrial development bonds. Even if section 103(c) does not prevent a bond from being treated as an obligation described in section 103(a)(1) and § 1.103–1, such bond shall nevertheless be treated as an obligation which is not described in section 103(a)(1) and § 1.103–1 if under section 103(d) it is an arbitrage bond. For purposes of section 103(c), the term "issue" includes a single obliga-

tion such as a single note issued in connection with a bank loan as well as a series of notes or bonds.

(b) *Industrial development bonds*—(1) *Definition.* For purposes of this section, the term "industrial development bond" means any obligation—

(i) Which is issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly in any trade or business carried on by any person who is not an exempt person (as defined in subparagraph (2) of this paragraph), and

(ii) The payment of the principal or interest on which, under the terms of such obligation or any underlying arrangement (as described in subparagraph (4) of this paragraph), is in whole or in major part (i.e., major portion)—

(*a*) Secured by any interest in property used or to be used in a trade or business,

(*b*) Secured by any interest in payments in respect of property used or to be used in a trade or business, or

(*c*) To be derived from payments in respect of property, or borrowed money, used or to be used in a trade or business.

See subparagraphs (3) and (4) of this paragraph for the trade or business test and the security interest test respectively.

(2) *Exempt person.* The term "exempt person" means a governmental unit as defined in this subparagraph, or an organization which is described in section 501(c)(3) and this subparagraph and is exempt from taxation under section 501(a). For purposes of this subparagraph, the term "governmental unit" means a State or local governmental unit (as defined in § 1.103-1). For purposes of this subparagraph, the term "governmental unit" also includes the United States of America (or an agency or instrumentality of the United States of America), but only in the case of obligations (i) issued on or before August 3, 1972, or (ii) issued after August 3, 1972, with respect to which a bond resolution or any other official action was taken and in reliance on such action either (*a*) construction of such facility to be financed with such obligations commenced or (*b*) a binding contract was entered into, or an irrevocable bid was submitted, prior to August 3, 1972, or (iii) issued after August 3, 1972, with respect to a program approved by Congress prior to such date but only if (*a*) a portion of such program has been financed by obligations issued prior to such date, to which section 103(a) applied pursuant to a ruling issued by the Commissioner or his delegate prior to such date and (*b*) construction of one or more facilities comprising a part of such program commenced prior to such date. For purposes of this subparagraph, a tax-exempt organization is an exempt person only with respect to a trade or business it carries on which is not an unrelated trade or business. Whether a particular trade or business carried on by a tax-exempt organization is an unrelated trade or business is determined by applying the rules of section 513(a) (relating to general rule for unrelated trade or business) and the regulations thereunder to the tax-exempt organization without regard to whether the organization is an organization subject to the tax imposed by section 511 (relating to imposition of tax on unrelated business income of charitable, etc., organizations).

(3) *Trade or business test.* (i) The trade or business test relates to the use of the proceeds of a bond issue. The test is met if all or a major portion of the proceeds of a bond issue is used in a trade or business carried on by a nonexempt person. For example, if all or a major portion of the proceeds of a bond issue is to be loaned to one or more private business users, or is to be used to acquire, construct, or reconstruct facilities to be leased or sold to such private business users, and such proceeds or facilities are to be used in trades or businesses carried on by them, such proceeds are to be used in a trade or business carried on by persons who are not exempt persons, and the debt obligations comprising the bond issue satisfy the trade or business test. If, however, less than a major portion of the proceeds of an issue is to be loaned to nonexempt persons or is to be used to acquire or construct facilities which will be used in a trade or business carried on by a nonexempt person, the debt obligations

will not be industrial development bonds. Also, when publicly-owned facilities which are intended for general public use, such as toll roads or bridges, are constructed with the proceeds of a bond issue and used by nonexempt persons in their trades or businesses on the same basis as other members of the public, such use does not constitute a use in the trade or business of a nonexempt person for purposes of the trade or business test.

(ii) In determining whether a debt obligation meets the trade or business test, the indirect, as well as the direct, use of the proceeds is to be taken into account. For example, the debt obligations comprising a bond issue do not fail to satisfy the trade or business test merely because the State or local governmental unit uses the proceeds to engage in a series of financing transactions for property to be used by private business users in trades or businesses carried on by them. Similarly, if such proceeds are to be used to construct facilities to be leased or sold to any nonexempt person for use in a trade or business it carries on, such proceeds are to be used in a trade or business carried on by a nonexempt person and the debt obligations comprising such issue satisfy the trade or business test. If such proceeds are to be used to construct facilities to be leased or sold to an exempt person who will, in turn, lease or sell the facilities to a nonexempt person for use in a trade or business, such proceeds are to be used in a trade or business carried on by a nonexempt person and the debt obligations comprising such issue satisfy the trade or business test. In addition, proceeds will be treated as being used in the trade or business of a nonexempt person in situations involving other arrangements, whether in a single transaction or in a series of transactions, whereby a nonexempt person uses property acquired with the proceeds of a bond issue in its trade or business.

(iii) The use of more than 25 percent of the proceeds of an issue of obligations in the trades or businesses of nonexempt persons will constitute the use of a major portion of such proceeds in such manner. In the case of the direct or indirect use of the proceeds of an issue of obligations or the direct or indirect use of a facility constructed, reconstructed, or acquired with such proceeds, the use by all nonexempt persons in their trades or businesses must be aggregated to determine whether the trade or business test is satisfied. If more than 25 percent of the proceeds of a bond issue is used in the trades or businesses of nonexempt persons, the trade or business test is satisfied. For special rules with respect to the acquisition of the output of facilities, see subparagraph (5) of this paragraph.

(4) *Security interest test.* The security interest test relates to the nature of the security for, and the source of, the payment of either the principal or interest on a bond issue. The nature of the security for, and the source of, the payment may be determined from the terms of the bond indenture or on the basis of an underlying arrangement. An underlying arrangement to provide security for, or the source of, the payment of the principal or interest on an obligation may result from separate agreements between the parties or may be determined on the basis of all the facts and circumstances surrounding the issuance of the bonds. The property which is the security for, or the source of, the payment of either the principal or interest on a debt obligation need not be property acquired with bond proceeds. The security interest test is satisfied if, for example, a debt obligation is secured by unimproved land or investment securities used, directly or indirectly, in any trade or business carried on by any private business user. A pledge of the full faith and credit of a State or local governmental unit will not prevent a debt obligation from otherwise satisfying the security interest test. For example, if the payment of either the principal or interest on a bond issue is secured by both a pledge of the full faith and credit of a State or local governmental unit and any interest in property used or to be used in a trade or business, the bond issue satisfies the security interest test. For rules with respect to the acquisition of the output of facilities see subparagraph (5) of this paragraph.

(5) *Trade or business test and security interest test with respect to certain output contracts.* (i) The use by one or more nonexempt persons of a major portion of the subparagraph (5) output of facilities such as electric energy, gas, or water facilities constructed, reconstructed, or acquired with the proceeds of an issue satisfies the trade or business test and the security interest test if such use has the effect of transferring to nonexempt persons the benefits of ownership of such facilities, and the burdens of paying the debt service on governmental obligations used directly or indirectly to finance such facilities, so as to constitute the indirect use by them of a major portion of such proceeds. Such benefits and burdens are transferred and a major portion of the proceeds of an issue is used indirectly by the users of the subparagraph (5) output of such a facility which is owned and operated by an exempt person where—

(*a*) (*1*) One nonexempt person agrees pursuant to a contract to take, or to take or pay for, a major portion (more than 25 percent) of the subparagraph (5) output (within the meaning of subdivision (ii) of this subparagraph) of such a facility (whether or not conditional upon the production of such output) or (*2*) two or more nonexempt persons, each of which pays annually a guaranteed minimum payment exceeding 3 percent of the average annual debt service with respect to the obligations in question, agree, pursuant to contracts, to take, or to take or pay for, a major portion (more than 25 percent) of the subparagraph (5) output of such a facility (whether or not conditioned upon the production of such output), and

(*b*) Payment made or to be made with respect to such contract or contracts by such nonexempt person or persons exceeds a major part (more than 25 percent) of the total debt service with respect to such issue of obligations.

(ii) For purposes of this subparagraph—

(*a*) Where a contract described in subdivision (i) of this subparagraph may be extended by the issuer of obligations described therein, the term of the contract shall be considered to include the period for which such contract may be so extended.

(*b*) The subparagraph (5) output of a facility shall be determined by multiplying the number of units produced or to be produced by the facility in 1 year by the number of years in the contract term of the issue of obligations issued to provide such facility. The number of units produced or to be produced by a facility in 1 year shall be determined by reference to its nameplate capacity (or where there is no nameplate capacity, its maximum capacity) without any reduction for reserves or other unutilized capacity. The contract term of an issue begins on the date the output of a facility is first taken, pursuant to a take or a take or pay contract, by a nonexempt person and ends on the latest maturity date of any obligation of the issue (determined without regard to any optional redemption dates). If, however, on or before the date of issue of a prior issue of governmental obligations issued to provide a facility, the issuer makes a commitment in the bond indenture or related document to refinance such prior issue with one or more subsequent issues of governmental obligations, then the contract term of the issue shall be determined with regard to the latest redemption date of any obligation of the last such refinancing issue with respect to such facility (determined without regard to any optional redemption dates). Where it appears that the term of an issue (or the terms of two or more issues) is extended for purposes of extending the contract term of an issue and thereby increasing the subparagraph (5) output of the facility provided by such issue, the subparagraph (5) output of such facility shall be determined by the Commissioner without regard to the provisions of this subdivision (*b*).

(*c*) The total debt service with respect to an issue of obligations shall be the total dollar amount (excluding any penalties) payable with respect to such issue over its entire term. The entire term of an issue begins on its date of issue and ends on the latest maturity date of any obligation of the issue (determined without regard to any op-

tional redemption dates). If, however, on or before the date of issue of a prior issue of governmental obligations the issuer makes a commitment in the bond indenture or related document to refinance such prior issue with one or more subsequent issues of governmental obligations, the entire term of the issue shall be determined with regard to the latest redemption date of any obligation of the last such refinancing issue (determined without regard to any optional redemption dates).

(*d*) Two or more nonexempt persons who are related persons (within the meaning of section 103(c)(6)(C)) shall be treated as one nonexempt person.

(c) *Examples.* The application of the rules contained in section 103(c) (2) and (3) and paragraph (b) of this section are illustrated by the following examples:

Example (1). State A and corporation X enter into an arrangement under which A is to provide a factory which X will lease for 20 years. The arrangement provides (1) that A will issue $10 million of bonds, (2) that the proceeds of the bond issue will be used to purchase land and to construct and equip a factory in accordance with X's specifications, (3) that X will rent the facility (land, factory, and equipment) for 20 years at an annual rental equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds, and (4) that such payments by X and the facility itself will be the security for the bonds. The bonds are industrial development bonds since they are part of an issue of obligations (1) all of the proceeds of which are to be used (by purchasing land and constructing and equipping the factory) in a trade or business by a nonexempt person, and (2) the payment of the principal and interest on which is secured by the facility and payments to be made with respect thereto.

Example (2). The facts are the same as in example (1) except that (1) X will purchase the facility, and (2) annual payments equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds will be made by X. The bonds are industrial development bonds for the reasons set forth in example (1).

Example (3). State B and corporation X enter into an arrangement under which B is to loan $10 million to X. The arrangement provides (1) that B will issue $10 million of bonds, (2) that the proceeds of the bond issue will be loaned to X to provide additional working capital and to finance the acquisition of certain new machinery, (3) that X will repay the loan in annual installments equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds, and (4) that the payments on the loan and the machinery will be the security for only the payment of the principal on the bonds. The bonds are industrial development bonds since they are part of an issue of obligations (1) all of the proceeds of which are to be used in a trade or business by a nonexempt person, and (2) the payment of the principal on which is secured by payments to be made in respect of property to be used in a trade or business. The result would be the same if only the payment of the interest on the bonds were secured by payments on the loan and machinery.

Example (4). The facts are the same as in example (1), (2), or (3) except that the annual payments required to be made by corporation X exceed the amount necessary to amortize the principal and pay the interest on the outstanding bonds. The bonds are industrial development bonds for the reasons set forth in such examples. The fact that corporation X is required to pay an amount in excess of the amount necessary to pay the principal and interest on the bonds does not affect their status as industrial development bonds. Similarly, if the annual payments required to be made by corporation X were sufficient to pay only a major portion of either the principal or the interest on the outstanding bonds, the bonds would be industrial development bonds for the reasons set forth in such examples.

Example (5). The facts are the same as in example (1), (2), (3), or (4) except that the issuer is a political subdivision which has taxing power and the bonds are general obligation bonds. Since both the trade or business and the security interest tests are met, the bonds are industrial development bonds notwithstanding the fact that they constitute an unconditional obligation of the issuer payable from its general revenues.

Example (6). (a) State C issues its general obligation bonds to purchase land and construct a hotel for use by the general public (i.e., tourists, visitors, travelers on business, etc.). The bond indenture provides (1) that C will own and operate the project for the period required to redeem the bonds, and (2) that the project itself and the revenues derived therefrom are the security for the bonds. The bonds are not industrial development bonds since (1) the proceeds are to be used by an exempt person in a trade or business carried on by such person, and (2) a major portion of such proceeds is not to be used, directly or indirectly, in a trade or business carried on by a nonexempt person. Use of the hotel by hotel guests who are travelling in connection with trades or busi-

nesses of nonexempt persons is not an indirect use of the hotel by such nonexempt persons for purposes of section 103(c).

(b) The facts are the same as in paragraph (a) of this example except that corporation Y enters into a long-term agreement with C that Y will rent more than one-fourth of the rooms on an annual basis for a period approximately equal to one half of the term of the bonds. The bonds are industrial development bonds because (1) a major portion of the proceeds used to construct the hotel is to be used in the trade or business of corporation Y (a nonexempt person) and (2) a major portion of the principal and interest on such issue will be derived from payments in respect of the property used in the trade or business of Y.

Example (7). (a) State D and corporation Y enter into an agreement under which Y will lease for 20 years three floors of a 12-story office building to be constructed by D on land which it will acquire. D will occupy the grade floor and the remaining eight floors of the building. The portion of the costs of acquiring the land and constructing the building which are allocated to the space to be leased by Y is not in excess of 25 percent of the total costs of acquiring the land and constructing the building. Such costs, whether attributable to the acquisition of land or the construction of the building, were allocated to leased space in the same proportion that the reasonable rental value of such leased space bears to the reasonable rental value of the entire building. From the facts and circumstances presented, it is determined that such allocation was reasonable. The arrangement between D and Y provides that D will issue $10 million of bonds, that the proceeds of the bond issue will be used to purchase land and construct an office building, that Y will lease the designated floor space for 20 years at its reasonable rental value, and that such rental payments and the building itself shall be security for the bonds. The bonds are not industrial development bonds since a major portion of the proceeds is not to be used, directly or indirectly, in the trade or business of a nonexempt person.

(b) The facts are the same as in paragraph (a) of this example except that corporation Y will lease four floors, and the costs allocated to these floors are in excess of 25 percent of D's investment in the land and building. The bonds are industrial development bonds because (1) a major portion of the building is to be used in the trade or business of a nonexempt person, and (2) a major portion of the principal and interest on such issue is secured by the rental payments on the building.

Example (8). The facts are the same as in paragraph (b) of example (7) except that, instead of leasing any space to corporation Y, State D will lease the four floors to numerous unrelated private business users to be used in their trades or businesses. No lease will have a term exceeding 2 years. A major portion of the principal and interest will be paid from the revenues that D will derive from such leases. The fact that the activities of D, an exempt person, may amount to a trade or business of leasing property is not material, and the bonds are industrial development bonds for the reasons set forth in paragraph (b) of example (7). The result would be the same in the case of long-term leases.

Example (9). State E issues its obligations to finance the construction of dormitories for educational institution Z which is an organization described in section 501(c)(3) and exempt from tax under section 501(a). The dormitories are to be owned and operated by Z and their operation does not constitute an unrelated trade or business. The bonds are not industrial development bonds since the proceeds are to be used by an exempt person in a trade or business carried on by such person which is not an unrelated trade or business, as determined by applying section 513(a) to Z.

Example (10). State F issues its obligations to finance the construction of a toll road and the cost of erecting related facilities such as gasoline service stations and restaurants. Such related facilities represent less than 25 percent of the total cost of the project and are to be leased or sold to nonexempt persons. The toll road is to be owned and operated by F. The revenues from the toll road and from the rental of related facilities are the security for the bonds. The bonds are not industrial development bonds since a major portion of the proceeds is not to be used, directly or indirectly, in the trades or businesses of nonexempt persons. The fact that vehicles owned by nonexempt persons engaged in their trades or businesses may use the road in common with, or as a part of, the general public is not material.

Example (11). City G issues its obligations to finance the construction of a municipal auditorium which it will own and operate. The use of the auditorium will be open to anyone who wishes to use it for a short period of time on a rate-scale basis. The rights of such a user are only those of a transient occupant rather than the full legal possessory interests of a lessee. It is anticipated that the auditorium will be used by schools, church groups, and fraternities, and numerous commercial organizations. The revenues from the rentals of the auditorium and the auditorium building itself will be the security for the bonds. The bonds are not industrial development bonds because such use is not a use in the trade or business of a nonexempt person.

Example (12). The facts are the same as in example (11) except that one nonexempt person will have a 20-year rental agreement providing for exclusive use of the entire auditorium for more than 3 months of each year at a rental comparable to that charged short-term users. The bonds are industrial development bonds since such use is a use in the trade or business of a nonexempt person and, therefore, a major portion of the proceeds of the issue will be used in the trade or business of a nonexempt person and a major portion of the principal or interest on such issue will be secured by a facility used in such trade or business and by payments with respect to such facility.

Example (13). In order to construct an electric generating facility of a size sufficient to take advantage of the economies of scale: (1) City H will issue $50 million of its 25-year bonds and Z (a privately owned electric utility) will use $100 million of its funds for construction of a facility they will jointly own as tenants in common. (2) Each of the participants will share in the ownership, output, and operating expenses of the facility in proportion to its contribution to the cost of the facility, that is, one-third by H and two-thirds by Z. (3) H's bonds will be secured by H's ownership in the facility and by revenues to be derived from the sale of H's share of the annual output of the facility. (4) Because H will need only 50 percent of its share of the annual output of the facility, it agrees to sell to Z 25 percent of its share of such annual output for a period of 20 years pursuant to a contract under which Z agrees to take or pay for such power in all events. The facility will begin operation, and Z will begin to receive power, 4 years after the City H obligations are issued. The contract term of the issue will, therefore, be 21 years. (5) H also agrees to sell the remaining 25 percent of its share of the annual output to numerous other private utilities under a prevailing rate schedule including demand charges. (6) No contracts will be executed obligating any person other than Z to purchase any specified amount of the power for any specified period of time and no one such person (other than Z) will pay a demand charge or other minimum payment under conditions which, under paragraph (b)(5) of this section, result in a transfer of the benefits of ownership and the burdens of paying the debt service on obligations used directly or indirectly to provide such facilities. The bonds are not industrial development bonds because H's one-third interest in the facility (financed with bond proceeds) shall be treated as a separate property interest and, although 25 percent of H's interest in the annual output of the facility will be used directly or indirectly in the trade or business of Z, a nonexempt person, under the rule of paragraph (b)(5) of this section, such portion constitutes less than a major portion of the subparagraph (5) output of the facility. If more than 25 percent of the subparagraph (5) output of the facility were to be sold to Z pursuant to the take or pay contract, the bonds would be industrial development bonds since they would be secured by H's ownership in the facility and revenues therefrom, and under the rules of paragraph (b)(5) of this section a major portion of the proceeds of the bond issue would be used in the trade or business of Z, a nonexempt person.

Example (14). J, a political subdivision of a State, will issue several series of bonds from time to time and will use the proceeds to rehabilitate urban areas. More than 25 percent of the proceeds of each issue will be used for the rehabilitation and construction of buildings which will be leased or sold to nonexempt persons for use in their trades or businesses. There is no limitation either on the number of issues or the aggregate amount of bonds which may be outstanding. No group of bondholders has any legal claim prior to any other bondholders or creditors with respect to specific revenues of J, and there is no arrangement whereby revenues from a particular project are paid into a trust or constructive trust, or sinking fund, or are otherwise segregated or restricted for the benefit of any group of bondholders. There is, however, an unconditional obligation by J to pay the principal and interest on each issue of bonds. Further, it is apparent that J requires the revenues from the lease or sale of buildings to nonexempt persons in order to pay in full the principal and interest on the bonds in question. The bonds are industrial development bonds because a major portion of the proceeds will be used in the trades or businesses of nonexempt persons and, pursuant to an underlying arrangement, payment of the principal and interest is, in major part, to be derived from payments in respect of property or borrowed money used in the trades or businesses of nonexempt persons.

Example (15). Power Authority K, a political subdivision created by the legislature in State X to own and operate certain power generating facilities, sells all of the power from its existing facilities to four private utility systems under contracts executed in 1970, whereby such four systems are required to take or pay for specified portions of the total power output until the year 2000. Currently, existing facilities supply all of the present needs of the four utility systems but their future power requirements are expected to increase substantially. K issues 20-year general obligation bonds to construct a large nuclear generating facility. A fifth private utility system contracts with K to take or pay for 30 percent of the sub-

paragraph (5) output of the new facility. The balance of the power output of the new facility will be available for sale as required, but initially it is not anticipated there will be any need for such power. The revenues from the contract with the fifth private utility system will be sufficient to pay less than 25 percent of the principal or interest on the bonds. The balance, which will exceed 25 percent of the principal or interest on such bonds, will be paid from revenues from the contracts with the four systems from sale of power produced by the old facilities. The bonds will be industrial development bonds because a major portion of the proceeds will be used in the trade or business of a nonexempt person, and payment of the principal and interest, pursuant to an underlying arrangement, will be derived in major part from payments in respect of property used in the trades or businesses of nonexempt persons.

(d) *Certain refunding issues*—(1) *General rule.* In the case of an issue of obligations issued to refund the outstanding face amount of an issue of obligations, the proceeds of the refunding issue will be considered to be used for the purpose for which the proceeds of the issue to be refunded were used. The rules of this subparagraph shall apply regardless of the date of issuance of the issue to be refunded and shall apply to refunding issues to be issued to refund prior refunding issues.

(2) *Obligations issued prior to effective date.* In the case of an issue of obligations issued to refund the outstanding face amount of an issue of obligations issued on or before April 30, 1968 (or before January 1, 1969, if the transitional rules of § 1.103-12 are applicable) which would have been industrial development bonds within the meaning of section 103(c)(2) had they been issued after such date, the refunding issue shall not be considered to be an issue of industrial development bonds if it does not make funds available for any purpose other than the debt service on the obligations. For rules as to arbitrage bonds, see section 103(d).

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). In 1969, State A issued $20 million of 20-year revenue bonds the proceeds of which were used to contruct a sports facility which qualifies as an exempt facility described in section 103(c)(4)(B) and paragraph (c) of § 1.103-8. The sports facility will be owned and operated by X, a nonexempt person, for the use of the general public. In 1975, A issues $15 million of revenue bonds in order to refund the outstanding face amount of the 1969 issue. Since the proceeds of the 1969 issue were used for an exempt facility, the proceeds of the 1975 refunding issue will be considered to be used for the same purposes and section 103(c)(1) shall not apply to the 1975 refunding issue. The result would have been the same if the original issue had been issued in 1965. For rules as to a refunding obligation held by substantial users of facilities constructed with the proceeds of the issue refunded, see section 103(c)(7) and § 1.103-11.

Example (2). In 1967, prior to the effective date of section 103(c), city B issued $10 million of revenue bonds the proceeds of which were used to construct a manufacturing facility for corporation Y, a nonexempt person. Lease payments by Y were security for the bonds. In 1975, B issue $7 million of revenue bonds in order to retire the outstanding face amount of the 1967 issue. The interest rate of the 1975 issue is one and one-half percentage points lower than the interest rate on the 1967 issue. Both issues sold at par. All of the terms of the 1975 issue are the same as the terms of the 1967 issue with the exception of the interest rate. The 1975 refunding issue will not be considered to be an issue of industrial development bonds since the refunding issue will not make funds available for any purpose other than the debt service on the outstanding obligations.

Example (3). The facts are the same as in example (2) except that the interest rate on the refunding issue is the same as the interest rate on the issue to be refunded. Assume further that city B issued the 1975 refunding issue in order to extend the term of the obligations issued in 1967 as the result of its inability to pay such obligations due to insufficient revenues. The results will be the same as in example (2) for the reasons stated therein.

[T.D. 7199, 37 FR 15486, Aug. 3, 1972; 37 FR 16177, Aug. 11, 1972]

§ 1.103-8 Interest on bonds to finance certain exempt facilities.

(a) *In general*—(1) *General rule.* (i) Under section 103(c)(4), interest paid on an issue of obligations issued by a State or local governmental unit (as defined in § 1.103-1) is not includable in gross income if substantially all of the proceeds of such issue is to be used to provide one or more of the exempt facilities listed in subparagraphs (A)

through (G) of section 103(c)(4) and in this section. However, interest on an obligation of such issue is includable in gross income if the obligation is held by a substantial user or a related person (as described in section 103(b)(8) and § 1.103–11). If substantially all of the proceeds of a bond issue is to be used to provide such exempt facilities, the debt obligations are treated as obligations described in section 103(a)(1) and § 1.103–1 even though such obligations are industrial development bonds as defined in section 103(c)(2) and § 1.103–7. Substantially all of the proceeds of an issue of governmental obligations are used to provide an exempt facility if 90 percent or more of such proceeds are so used. For purposes of this "substantially all" test, two rules apply. First, proceeds are reduced by amounts properly allocable on a pro rata basis between providing the exempt facility and other uses of the proceeds. Second, amounts used to provide an exempt facility include amounts paid or incurred which are chargeable to the facility's capital account or would be so chargeable either with a proper election by a taxpayer (for example, under section 266) or but for a proper election by a taxpayer to deduct such amounts.

(ii) The provisions of subdivision (i) of this subparagraph shall also apply to an issue of obligations substantially all of the proceeds of which is to be used to provide exempt facilities described in this section and for either or both of the following purposes: (*a*) To acquire or develop land as the site for an industrial park described in section 103(c)(5) and § 1.103–9, (*b*) to provide facilities to be used by an exempt person.

(iii) Section 103(c)(4) only becomes applicable where the bond issue meets both the trade or business and the security interest tests so that obligations are industrial development bonds within the meaning of section 103(c)(2). For rules as to exempt facilities including property functionally related and subordinate to such facilities, see subparagraph (3) of this paragraph. For rules with respect to the ultimate use of proceeds of obligations, see paragraph (4) of this subparagraph. For rules which limit the application of the provisions of this section see subparagraph (5) of this paragraph. For the interrelationship of the rules provided in this section and the exemption for certain small issues provided in section 103(c)(6), see § 1.103–10.

(2) *Public use requirement.* To qualify under section 103(c)(4) and this section as an exempt facility, a facility must serve or be available on a regular basis for general public use, or be a part of a facility so used, as contrasted with similar types of facilities which are constructed for the exclusive use of a limited number of nonexempt persons in their trades or businesses. For example, a private dock or wharf owned by or leased to, and serving only a single manufacturing plant would not qualify as a facility for general public use, but a hangar or repair facility at a municipal airport, or a dock or a wharf, would qualify even if it is owned by, or leased or permanently assigned to, a nonexempt person provided that such nonexempt person directly serves the general public, such as a common passenger carrier or freight carrier. Similarly, an airport owned or operated by a nonexempt person for general public use is a facility for public use, as is a dock or wharf which is a part of a public port. However, a landing strip which, by reason of a formal or informal agreement or by reason of geographic location, will not be available for general public use does not satisfy the public use requirement. Sewage or solid waste disposal facilities and air or water pollution control facilities, described in sections 103(c)(4) (E) and (F) and paragraphs (f) and (g) of this section, will be treated in all events as serving a general public use although they may be part of a nonpublic facility such as a manufacturing facility used in the trade or business of a nonexempt user.

(3) *Functionally related and subordinate.* An exempt facility includes any land, building, or other property functionally related and subordinate to such facility. Property is not functionally related and subordinate to a facility if it is not of a character and size commensurate with the character and

size of such facility. Since substantially all of the proceeds of a bond issue must be used for the exempt facility (or for any combination of exempt facilities, industrial parks, and facilities to be used by exempt persons), including property functionally related and subordinate thereto, an insubstantial amount of the proceeds of a bond issue may be used for facilities which are neither exempt facilities (or a combination of exempt facilities, industrial parks and facilities to be used by exempt persons) nor functionally related and subordinate to exempt facilities. Thus, for example, where substantially all of the proceeds of an urban redevelopment bond issue are to be used by a State urban redevelopment agency for residential real property for family units within the meaning of section 103(c)(4)(A) and paragraph (b) of this section, an insubstantial amount may be used for an industrial or commercial project or for any other purpose that is not functionally related and subordinate to the residential real property for family units.

(4) *Ultimate use of proceeds.* The question whether substantially all of the proceeds of an issue of obligations are to be used to provide one or more of the exempt facilities listed in subparagraphs (A) through (G) of section 103(c)(4) and in this section is to be resolved by reference to the ultimate use of such proceeds. For example, such proceeds will be treated as used to provide residential real property for family units whether the State or local governmental unit (i) constructs such property and leases or sells it to any person who is not an exempt person for use in such person's trade or business of selling or leasing such property; (ii) lends the proceeds to any such person for such purpose; or (iii) lends the proceeds to banks or other financial institutions in order to increase the supply of funds for mortgage lending under conditions requiring such banks or other financial institutions to use such proceeds only for further mortgage lending on residential real property for family units.

(5) *Limitation.* (i) To qualify under section 103(c)(4) and this section as an exempt facility, such facility (*a*) must be one which is described in subdivision (ii) of this subparagraph and, if the original use of the facility commences prior to the date of issue of obligations issued to provide such facility, the facility is described in subdivision (iv) of this subparagraph or (*b*) if the construction, reconstruction, or acquisition of the facility commences on or after September 2, 1972, the facility is described in subdivision (iii) or (iv) of this subparagraph.

(ii) If the construction, reconstruction, or acquisition of a facility commences before September 2, 1972, the facility is described in this subdivision if a bond resolution with respect to obligations to provide such facility had been adopted by, or some other similar official action toward the issuance of obligations to provide such facility had been taken by, the issuer of such obligations prior to the date the entire facility is first placed in service. The determination as to whether a stage or portion of a single facility, or an entire facility, was placed in service is determined according to the facts and circumstances of each situation. However, the date on which an entire facility is placed in service shall not be earlier than the date on which—

(*a*) It has reached a degree of completion which would permit operation at substantially the level for which it is designed, and

(*b*) It is, in fact, in operation at such level.

For example, a newly constructed air pollution control facility for a manufacturing plant is not first placed in service within the meaning of this subdivision merely as a result of its initial operation at an air pollution abatement level substantially below that contemplated for the completed facility.

(iii) If the original use of a facility commences (or the acquisition of a facility occurs) on or after the date of issue of obligations issued to provide such facility, the facility is described in this subdivision if a bond resolution with respect to such obligations had been adopted by, or some other similar official action toward the issuance of such obligations had been taken by, the issuer of such obligations prior to the commencement of the construc-

tion, reconstruction, or acquisition of such facility. Temporary construction or other financing of a facility prior to the issuance of State or local governmental obligations to provide such facility will not cause such facility to be one which is not described in this subdivision.

(iv) If the original use of a facility commences prior to the date of issue of the obligations issued to provide such facility, the facility is described in this subdivision if no nonexempt person or a related person (as defined in section 103(c)(6)(C) and paragraph (e) of § 1.103-10)—

(*a*) Who was a substantial user (within the meaning of § 1.103-11) of such facility at any time during the 5-year period preceding the date of issue of such obligations, and

(*b*) Who receives, directly or indirectly, proceeds of the issue of obligations in question in an amount equal to 5 percent or more of the face amount of the issue (in payment for his interest in such facility)

will be a substantial user of such facility at any time during the 5-year period following such date of issue.

(v) A facility shall not be treated as one not described in subdivision (iv) of this subparagraph by reason of the use of the facility by such substantial user prior to the date of issue of the State or local obligations issued to provide the facility, provided that a bond resolution or other similar official action was taken by such issuer with respect to such obligations (*a*) prior to the commencement of the construction, reconstruction, or acquisition of such facility and such obligations are issued within 1 year after the entire facility was first placed in service or was acquired (whichever occurs last), or (*b*) in the case of a facility which is described in subdivision (ii) of this subparagraph, prior to the date the entire facility is first placed in service. See subdivision (ii) of this subparagraph for rules for determining when an entire facility is first placed in service. The provisions of this subdivision shall not apply with respect to an acquisition if any substantial user or a related person after the date of such acquisition was a substantial user before the date such bond resolution or other similar official action by such issuer was adopted.

(6) *Example.* The principles of this paragraph may be illustrated by the following example:

Example. State A issues its bonds and plans to use substantially all of the proceeds from such bond issue to purchase land and build a facility which will be for one of the purposes described in section 103(c)(4) and this section. The arrangement provides that (1) A will issue bonds the proceeds of which (after deducting bond election costs, costs of publishing notices, attorneys' fees, printing costs, trustees' fees for fiscal agents, and similar expenses) will be $20 million; (2) $18 million of the proceeds of the bond issue will be used to purchase land and to construct such facility; (3) $2 million of the proceeds will be used for an unrelated facility which will be used by X, a nonexempt person, in a separate trade or business and for a purpose not described in section 103(c)(4) or (5); (4) X will rent both facilities for 20 years at an annual rental equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds; and (5) such payments by X and the facilities will be the security for the bonds. On these facts, substantially all of the proceeds will be used in connection with an exempt facility described in section 103(c)(4) and this section. Accordingly, section 103(c)(1) does not apply to the bonds unless such bonds are thereafter held by a person who is a substantial user of the facilities or a related person within the meaning of section 103(b)(8) and § 1.103-11.

(b) *Residential real property*—(1) *General rule.* Section 103(c)(4)(A) provides that section 103(c)(1) shall not apply to obligations issued by a State or local governmental unit which are part of an issue substantially all of the proceeds of which are to be used to provide residential real property for family units. In order to qualify under section 103(c)(4)(A) and this paragraph as an exempt facility, the facility must satisfy the public use requirement of paragraph (a)(2) of this section by being available for use by members of the general public.

(2) *Family units defined.* (i) For purposes of section 103(c)(4)(A) and this paragraph, the term "family unit" means a building or any portion thereof which contains complete living facilities which are to be used on other than a transient basis by one or more persons and facilities functionally re-

lated and subordinate thereto. Thus, an apartment which is to be used on other than a transient basis by a single person or by a family which contains complete facilities for living, sleeping, eating, cooking, and sanitation, constitutes a family unit. Such a unit may be served by centrally located machinery and equipment as in a typical apartment building. To qualify as a family unit, the living facilities must be a separate, self-contained building or constitute one unit in a building substantially all of which consists of similar units, together with functionally related and subordinate facilities and areas. Hotels, motels, dormitories, fraternity and sorority houses, rooming houses, hospitals, sanitariums, rest homes, and trailer parks and courts for use on a transient basis do not constitute residential real property for family units.

(ii) Under paragraph (a)(3) of this section, facilities which are functionally related and subordinate to residential real property actually used for family units include, for example, facilities for use by the occupants such as a swimming pool, a parking area, and recreational facilities.

(c) *Sports facilities*—(1) *General rule.* Section 103(c)(4)(B) provides that section 103(c)(1) shall not apply to obligations issued by a State or local governmental unit which are part of an issue substantially all of the proceeds of which are to be used to provide sports facilities. In order to qualify as an exempt facility under section 103(c)(4)(B) and this paragraph, the facility must satisfy the public use requirement of paragraph (a)(2) of this section by being available for use by members of the general public either as participants or as spectators.

(2) *Sports facility defined.* (i) For purposes of section 103(c)(4)(B) and this paragraph, the term "sports facilities" includes both outdoor and indoor facilities. The facility may be designed either as a spectator or as a participation facility. For example, the term includes both indoor and outdoor stadiums for baseball, football, ice hockey, or other sports events, as well as facilities for the participation of the general public in sports activities, such as golf courses, ski slopes, swimming pools, tennis courts, and gymnasiums. The term does not include, however, facilities such as a golf course, swimming pool, or tennis court, which are constructed for use by members of a private club or as integral or subordinate parts of a hotel or motel, or the use of which will be restricted to a special class or group or to guests of a particular hotel or motel, since they are not facilities for the use of the general public as required by paragraph (a)(2) of this section.

(ii) Under paragraph (a)(3) of this section, facilities which are functionally related and subordinate to a sports facility, such as a parking lot, clubhouse, ski slope warming house, bath house, or ski tow, are considered to be part of a sports facility. A ski lodge which consists primarily of overnight accommodations is not functionally related and subordinate to a sports facility.

(d) *Convention or trade show facilities*—(1) *General rule.* Section 103(c)(4)(C) provides that section 103(c)(1) shall not apply to obligations issued by a State or local governmental unit which are a part of an issue substantially all of the proceeds of which are to be used to provide convention or trade show facilities. In order to qualify under section 103(c)(4)(C) and this paragraph as an exempt facility, the facility must satisfy the public use requirement of paragraph (a)(2) of this section by being available for an appropriate charge or rental, on a rate scale basis, for use by members of the general public. The public use requirement is not satisfied if the use of a convention or trade show facility is limited by long-term leases to a single user or group of users.

(2) *Convention or trade show facilities defined.* For purposes of section 103(c)(4)(C) and this paragraph, the term "convention or trade show facilities" means special-purpose buildings or structures, such as meeting halls

and display areas, which are generally used to house a convention or trade show, including, under paragraph (a)(3) of this section, facilities functionally related and subordinate to such facilities such as parking lots or railroad sidings. A hotel or motel which is available to the general public, whether or not it is intended primarily to house persons attending or participating in a convention or trade show, is neither a convention or trade show facility nor functionally related and subordinate thereto.

(e) *Certain transportation facilities*—(1) *General rule.* Section 103(c)(4)(D) provides that section 103(c)(1) shall not apply to obligations issued by a State or local governmental unit which are part of an issue substantially all of the proceeds of which are to be used to provide (i) airports, docks, wharves, mass commuting facilities, or public parking facilities, or (ii) storage or training facilities directly related to any such facility. In order to qualify under section 103(c)(4)(D) and this paragraph as an exempt facility, the facility must satisfy the public use requirement of paragraph (a)(2) of this section by being available for use by members of the general public or for use by common carriers or charter carriers which serve members of the general public. A dock or wharf which is part of a public port (or a public port to be constructed in accordance with a plan which has been finally adopted on the date the obligations in question are issued) satisfies the public use test. A parking lot will be available for use by the general public unless more than an insubstantial portion thereof will be used exclusively by or for the benefit of a nonexempt person by reason of a formal or informal agreement or by reason of the remote geographic location of the facility.

(2) *Definitions.* For purposes of section 103(c)(4)(D) and this paragraph—

(i) With respect to bonds sold at or before 5:00 p.m. EST on December 29, 1978, an airport includes service accommodations for the public such as terminals, retail stores in such terminals, runways, hangars, loading facilities, repair shops, parking areas, and facilities which, under paragraph (a)(3) of this section, are functionally related and subordinate to the airport, such as facilities for the preparation of in-flight meals, restaurants, and accommodations for temporary or overnight use by passengers, and other facilities functionally related to the needs or convenience of passengers, shipping companies, and airlines. The term "airport" does not include a landing strip which, by reason of a formal or informal agreement, or by reason of geographic location, will not be available for general public use.

(ii) With respect to bonds sold after 5:00 p.m. EST on December 29, 1978—

(*a*) An airport includes facilities which are directly related and essential to—

(*1*) Servicing aircraft or enabling aircraft to take off and land, or

(*2*) Transferring passengers or cargo to or from aircraft.

A facility does not satisfy either of the foregoing requirements if the facility need not be located at, or in close proximity to, the take-off and landing area in order to perform its function. Examples of facilities which satisfy those requirements are terminals, runways, hangars, loading facilities, repair shops, and land-based navigation aids such as radar installation.

(*b*) Under paragraph (a)(3) of this section, an airport includes facilities other than those described in paragraph (e)(2)(ii)(*a*) only if they are functionally related and subordinate to an airport (as defined in paragraph (e)(2)(ii)(*a*)). A facility (or part thereof) is not functionally related and subordinate to an airport if the facility (or part thereof)—

(*1*) Is not of a character and size commensurate with the character and size of the airport at or adjacent to which the facility is located, or

(*2*) Is not located at or adjacent to that airport.

A facility may satisfy the character and size requirement although it provides minimal benefits to other airports. For example, a facility for the preparation of in-flight meals which has capacity sufficient to prepare all in-flight meals for aircraft departing the airport where the facility is located qualifies although some meals may be consumed in transit between other airports. Other examples of facilities functionally related and subordinate to an airport are restaurants and retail stores located in terminals, ground transportation parking areas, and accommodations for temporary or overnight use by passengers. Unimproved land (including agricultural land) that is adjacent to an airport and that is impaired by a significant level of airport noise is functionally related and subordinate to the airport if after its acquisition that land will not be converted to a use that is incompatible with the level of airport noise. Adjacent land with existing improvements also may be functionally related and subordinate to an airport by reason of impairment by a significant level of airport noise but only if the use of such land before its acquisition is incompatible with the airport noise level, its use after acquisition is to be compatible, and the post-acquisition use will be essentially different from the pre-acquisition use. Notwithstanding the foregoing, an interest in such improved land acquired solely to mitigate damages attributable to airport noise is treated as functionally related and subordinate to the airport. Thus, for example, amounts allocated to imposing a servitude on improved land adjacent to an airport restricting its future use to uses compatible with airport noise are treated as amounts allocated to property functionally related and subordinate to an airport. For the purpose of determining whether land is impaired by a significant level of airport noise, any generally accepted noise estimating methodology may be used. For example, a Noise Exposure Forecast (NEF), a method for composite noise rating recommended by the Federal Aviation Administration to measure the impact of airport noise, may be used for this purpose. Compatibility may be determined by reference to regulations or general guidelines published by the Federal Aviation Administration under section 102 of the Aviation Safety and Noise Abatement Act of 1979 (49 U.S.C. 2102), or sections 11(3)(C) and 18(a)(4) of the Airport and Airway Development Act of 1970, as amended (49 U.S.C. 1711(3)(C) and 1718(a)(4)), concerning uses of land impaired by a significant level of airport noise, or, where available, by reference to the airport compatibility plan specifically addressing what constitutes a compatible use of that land.

(*c*) As an illustration of the rules of this paragraph (e)(2)(ii), an office building (or office space within a building) or a computer facility, either of which serves a system-wide or regional function of an airline, is not considered part of an airport since that facility is not described in either paragraph (e)(2)(ii)(*a*) or (*b*). However, a maintenance or overhaul facility which services aircraft is considered part of an airport under paragraph (e)(2)(ii)(*a*) since that facility is directly related and essential to servicing aircraft and must be located where aircraft take off and land in order to perform its function.

(iii) A dock or wharf includes property which, under paragraph (a)(3) of this section, is functionally related and subordinate to a dock or wharf such as the structure alongside which a vessel docks, the equipment needed to receive and to discharge cargo and passengers from the vessel, such as cranes and conveyors, related storage, handling, office, and passenger areas, and similar facilities.

(iv) A mass commuting facility includes real property together with improvements and personal property used therein, such as machinery, equipment, and furniture, serving the general public commuting on a day-to-day basis by bus, subway, rail, ferry, or other conveyance which moves over prescribed routes. Such property also includes terminals and facilities which, under paragraph (a)(3) of this section, are functionally related and subordinate to the mass commuting facility, such as parking garages, car barns, and repair shops. Use of mass commuting facilities by noncommuters in

common with commuters is immaterial. Thus, a terminal leased to a common carrier bus line which serves both commuters and long distance travelers would qualify as an exempt facility.

(3) *Related storage or training facility.* Section 103 (b)(4)(D) includes only those storage and training facilities which are both (i) directly related to a facility to which subparagraph (1)(i) or (ii) of this paragraph applies and (ii) physically located on or adjacent to such a facility. For example, a storage facility would include a grain elevator, silo, warehouse, or oil and gas storage tank used in connection with a dock or wharf and located on or adjacent to such dock or wharf. Similarly, a training facility would include a building located at or adjacent to an airport for the training of flight personnel or a paved area immediately adjoining a bus garage used to train bus drivers.

(4) *Examples.* The principles of this paragraph may be illustrated by the following examples:

Example (1). B Airport Authority, a political subdivision of State A, owns and operates B Airport. B Airport Authority adds several runways. In view of the expanded area impaired by significant levels of airport noise, the Authority proposes to issue bonds the proceeds of which are to be used to acquire a hospital located adjacent to the airport. The noise level on the acquired property is 40 NEF. By reference to a noise exposure map setting forth noncompatible land uses and by reference to guidelines published by the Federal Aviation Administration, it is established that continued use of the land for a hospital is not compatible with the noise level. Prior to issuing the bonds, B contracts to lease the property to Corporation C to be used for warehouse space. Within 18 months of the bonds' issuance C will remodel the hospital (previously owned by D, who is unrelated to C) with its own funds and rent the facility as a warehouse. Use as a warehouse is determined to be compatible with the level of airport noise impairing the land. The improved land and prospective revenues from the facility's rental are security for the proposed issuance. Based on the foregoing, the acquired land satisfies the public use test. Furthermore, it is functionally related and subordinate to the airport because the improvements are to be used in an essentially different manner than prior to the land's acquisition. The bonds are industrial development bonds. However, section 103(b)(1) does not apply unless the provisions of section 103(b)(8) and § 1.103-11 apply.

Example (2). The facts are the same as in Example (1) except that a substantial portion of the proceeds of the bond issue is allocated to the acquisition of a limited interest in an additional tract of land (also impaired by airport noise measured at 40 NEF) on which an office building stands. The limited interest holds B harmless for damages caused by airport noise and restricts uses of the tract after the building is retired to those compatible with noise levels caused by the airport. Based on the foregoing, such interest satisfies the public use test. Furthermore, the interest is functionally related and subordinate to the airport because it is solely to mitigate damage attributable to airport noise, in part by restricting future land uses. The bonds are industrial development bonds. However, section 103(b)(1) does not apply unless the provisions of section 103(b)(8) or § 1.103-11 apply.

Example (3). On June 1, 1980, C Airport Authority, a political subdivision of State D, issues obligations the proceeds of which are loaned to E Corporation, a nonexempt person, and used to construct a hotel adjacent to the main terminal building at C Airport. E Corporation will be unconditionally liable for repayment of the proposed obligations. The hotel to be constructed will consist of rooms for temporary and overnight accommodations and conference facilities (*e.g.*, rooms designed for conducting large meetings). Although because of its location the hotel is not expected to receive more than *de minimis* use from persons other than those arriving at or departing from C Airport, it is expected to be used as a site for conferences and, as such, will constitute the principal destination of a significant number of persons using its accommodations and conference facilities. Because the hotel is intended to accommodate those staying for conferences the number of rooms is significantly greater than the number necessary for accommodations for temporary or overnight use by passengers and thus is not of a size commensurate with the needs of the airport. Consequently, applying the provisions, of § 1.103-8(e)(2)(ii)(*b*) the hotel is not functionally related and subordinate to C Airport. Based on the foregoing, the obligations are industrial development bonds and interest thereon is not excluded from gross income by reason of subsections (a)(1) and (b)(4) of section 103.

Example (4). In 1976 B becomes a limited partner in partnership BG. In 1978 B contributes B's entire interest in BG to a charitable organization described in section 170(c). At the time of the contribution all of the partnership liabilities are liabilities for which neither B nor G has assumed any personal liability and B's proportionate

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share of which is $9,000. The charitable organization does not pay any cash or other property to B, but takes the partnership interest subject to the $9,000 of liabilities. Assume that the contribution is treated as a bargain sale to a charitable organization and that under section 1011(b) $3,000 is determined to be the portion of B's basis in the partnership interest allocable to the sale. Under section 752(d) and this section, the $9,000 of liabilities is treated by B as money received, thereby making B's amount realized $9,000. B's gain realized is $6,000 ($9,000 - $3,000).

Example (5). In 1975 C, an individual, creates T, an irrevocable trust. Due to certain powers expressly retained by C, T is a "grantor trust" for purposes of subpart E of part 1 of subchapter J of the Code and therefore C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. In 1978, when the adjusted basis of the partnership interest held by T is $1,200, C renounces the powers previously and expressly retained that initially resulted in T being classified as a grantor trust. Consequently, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. At the time of the renunciation all of P's liabilities are liabilities on which none of the partners have assumed any personal liability and the proportionate share of which of the interest held by T is $11,000. Since prior to the renunciation C was the owner of the entire trust, C was considered the owner of all the trust property for Federal income tax purposes, including the partnership interest. Since C was considered to be the owner of the partnership interest, C not T, was considered to be the partner in P during the time T was a "grantor trust". However, at the time C renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor C. On the transfer, C's share of partnership liabilities ($11,000) is treated as money received. Accordingly, C's amount realized is $11,000 and C's gain realized is $9,800 ($11,000 - $1,200).

Example (6). In 1977 D purchases an asset for $7,500. D pays the seller $1,500 in cash and signs a note payable to the seller for $6,000. D is not personally liable for repayment but pledges as security the newly purchased asset. In the event of default, the seller's only recourse is to the asset. During the years 1977 and 1978 D takes depreciation deductions on the asset totaling $4,200 thereby reducing D's basis in the asset to $3,300 ($7,500 - $4,200). In 1979 D transfers the asset to a trust which is not a "grantor trust" for purposes of subpart E of part 1 of subchapter J of the Code. Therefore D is not treated as the owner of the trust. The trust takes the asset subject to the liability and in addition pays D $750 in cash. Prior to the transfer D had reduced the amount outstanding on the liability to $4,700. D's amount realized on the transfer is $5,450 ($4,700 + $750). Since D's adjusted basis is $3,300, D's gain realized is $2,150 ($5,450 - $3,300).

Example (7). In 1974 E purchases a herd of cattle for breeding purposes. The purchase price is $20,000 consisting of $1,000 cash and a $19,000 note. E is not personally liable for repayment of the liability and the seller's only recourse in the event of default is to the herd of cattle. In 1977 E transfers the herd back to the original seller thereby satisfying the indebtedness pursuant to a provision in the original sales agreement. At the time of the transfer the fair market value of the herd is $15,000 and the remaining principal balance on the note is $19,000. At that time E's adjusted basis in the herd is $16,500 due to a deductible loss incurred when a portion of the herd died as a result of disease. As a result of the indebtedness being satisfied, E's amount realized is $19,000 notwithstanding the fact that the fair market value of the herd was less than $19,000. E's realized gain is $2,500 ($19,000 - $16,500).

Example (8). In 1980, F transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value ($6,000). In addition, F has income from the discharge of indebtedness of $1,500 ($7,500 - $6,000).

(f) *Certain public utility facilities*—(1) *General rule.* (i) Section 103(c)(4)(E) provides that section 103(c)(1) shall not apply to obligations issued by a State or local governmental unit which are part of an issue substantially all of the proceeds of which are to be used to provide sewage disposal facilities, solid waste disposal facilities, or facilities for the local furnishing of electric energy or gas. In order to qualify under section 103(c)(4)(E) as an exempt facility, the facility must satisfy the public use requirement of paragraph (a)(2) of this section. A public utility facility described in this subparagraph (with the exception of sewage and solid waste

disposal facilities which will be treated in all events as serving the general public) will satisfy the public use requirement only if such facility, or the output thereof, is available for use by members of the general public.

(ii) A facility for the local furnishing of electric energy or gas is, for purposes of applying the public use test in paragraph (a)(2) of this section, available for use by members of the general public if (*a*) the owner or operator of the facility is obligated, by a legislative enactment, local ordinance, regulation, or the equivalent thereof, to furnish electric energy or gas to all persons who desire such services and who are within the service area of the owner or operator of such facility, and (*b*) it is reasonably expected that such facility will serve or be available to a large segment of the general public in such service area. For rules with respect to facilities for the furnishing of water, see paragraph (h) of this section.

(2) *Definitions.* For purposes of section 103(c)(4)(E) and this paragraph—

(i) The term "sewage disposal facilities" means any property used for the collection, storage, treatment, utilization, processing, or final disposal of sewage.

(ii) (*a*) The term "solid waste disposal facilities" means any property or portion thereof used for the collection, storage, treatment, utilization, processing, or final disposal of solid waste. Only expenditures for that portion of property which is a solid waste disposal facility qualify as expenditures for solid waste disposal facilities. The fact that a facility which otherwise qualifies as a solid waste disposal facility operates at a profit will not, of itself, disqualify the facility as an exempt facility. However, whether a collection or storage facility qualifies as a solid waste disposal facility depends upon all of the facts and circumstances. Thus, land and facilities for the collection of materials to form a slag heap which is not preliminary to the recycling or other final disposal of such materials within a reasonable period of time will not qualify. The term does not include facilities for collection, storage, or disposal of liquid or gaseous waste except where such facilities are facilities which, under paragraph (a)(3) of this section, are functionally related and subordinate to a solid waste disposal facility.

(*b*) The term "solid waste" shall have the same meaning as in section 203(4) of the Solid Waste Disposal Act (42 U.S.C. 3252(4)), except that for purposes of this paragraph, material will not qualify as solid waste unless, on the date of issue of the obligations issued to provide the facility to dispose of such waste material, it is property which is useless, unused, unwanted, or discarded solid material, which has no market or other value at the place where it is located. Thus, where any person is willing to purchase such property, at any price, such material is not waste. Where any person is willing to remove such property at his own expense but is not willing to purchase such property at any price, such material is waste. Section 203(4) of the Solid Waste Disposal Act provides that:

> (4) The term "solid waste" means garbage, refuse, and other discarded solid materials, including solid-waste materials resulting from industrial, commercial, and agricultural operations, and from community activities, but does not include solids or dissolved material in domestic sewage or other significant pollutants in water resources, such as silt, dissolved or suspended solids in industrial waste water effluents, dissolved materials in irrigation return flows or other common water pollutants.

(*c*) A facility which disposes of solid waste by reconstituting, converting, or otherwise recycling it into material which is not waste shall also qualify as a solid waste disposal facility if solid waste (within the meaning of (*b*) of this subdivision (ii) constitutes at least 65 percent, by weight or volume, of the total materials introduced into the recycling process. Such a recycling facility shall not fail to qualify as a solid waste disposal facility solely because it operates at a profit.

(*d*) For rules relating to property which has both a solid waste disposal function and a function other than the disposal of solid waste, see § 17.1 of this chapter.

(iii) The term "facilities for the local furnishing of electric energy or gas" means property which—

(*a*) Is either property of a character subject to the allowance for depreciation provided in section 167 or land,

(*b*) Is used to produce, collect, generate, transmit, store, distribute, or convey electric energy or gas.

(*c*) Is used in the trade or business of furnishing electric energy or gas, and

(*d*) Is a part of a system providing service to the general populace of one or more communities or municipalities, but in no event more than 2 contiguous counties (or a political equivalent) whether or not such counties are located in one State.

For purposes of this subdivision, a city which is not within, or does not consist of, one or more counties (or a political equivalent) shall be treated as a county (or a political equivalent). A facility for the generation of electric energy otherwise qualifying under this subdivision will not be disqualified because it is connected to a system for interconnection with other public utility systems for the emergency transfer of electric energy.

The facilities need not be located in the area served by them. Also, the term "facilities for the local furnishing of electric energy or gas" does not include coal, oil, gas, nuclear cores, or other materials performing a similar function.

(g) *Air or water pollution control facilities*—(1) *General rule.* Section 103(c)(4)(F) provides that section 103(c)(1) shall not apply to obligations issued by a State or local governmental unit which are part of an issue substantially all of the proceeds of which are to be used to provide air or water pollution control facilities. Such facilities are in all events treated as serving the general public and, thus, satisfy the public use requirement of paragraph (a)(2) of this section.

(2) *Definitions.* (i) For purposes of section 103(c)(4)(F) and this paragraph, property is a pollution control facility to the extent that the test of either subdivision (iii) or (iv) of this subparagraph is satisfied, but only if—

(*a*) It is property which is described in subdivision (ii) of this subparagraph and is either of a character subject to the allowance for depreciation provided in section 167 or land, and

(*b*) Either (*1*) a Federal, State, or local agency exercising jurisdiction has certified that the facility, as designed, is in furtherance of the purpose of abating or controlling atmospheric pollutants or contaminants, or water pollution, as the case may be, or (*2*) the facility is designed to meet or exceed applicable Federal, State, and local requirements for the control of atmospheric pollutants or contaminants, or water pollution, as the case may be, in effect at the time the obligations, the proceeds of which are to be used to provide such facilities, are issued.

(ii) Property is described in this subdivision if it is property to be used, in whole or in part, to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, or storing pollutants, contaminants, wastes, or heat. In the case of property to be used to control water pollution, such property includes the necessary intercepting sewers, pumping, power, and other equipment, and their appurtenances. For rules relating to facilities which remove pollutants from fuel or certain other items, see subdivision (vi) of this subparagraph.

(iii) In the case of an expenditure for property which is designed for no significant purpose other than the control of pollution, the total expenditure for such property satisfies the test of this subdivision. Thus, where property which is to serve no function other than the control of pollution is to be added to an existing manufacturing or production facility, the total expenditure for such property satisfies the test of this subdivision. Also, if an expenditure for property would not be made but for the purpose of controlling pollution, and if the expenditure has no significant purpose other than the purpose of pollution control, the total expenditure for such property satisfies the test of this subdivision even though such property serves one or more functions in addition to its function as a pollution control facility.

(iv) In the case of property to be placed in service for the purpose of controlling pollution and for a significant purpose other than controlling pollution, only the incremental cost of such facility satisfies the test of this

subdivision. The "incremental cost" of property is the excess of its total cost over that portion of its cost expended for a purpose other than the control of pollution.

(v) An expenditure has a significant purpose other than the control of pollution if it results in an increase in production or capacity, or in a material extension of the useful life of a manufacturing or production facility or a part thereof.

(h) *Water facilities*—(1) *General rule.* Section 103(c)(4)(G) provides that section 103(c)(1) shall not apply to obligations issued by a State or local governmental unit which are part of an issue substantially all of the proceeds of which are to be used to provide facilities for the furnishing of water which are available, on reasonable demand, to members of the general public. A water facility will satisfy the public use test of paragraph (a)(2) of this section if it will provide water, on reasonable demand, to any member of the general public within the service area of the water system of which such facility is a part.

(2) *Definition.* For purposes of section 103(c)(4)(G) and this paragraph, the "water facilities" include artesian wells, reservoirs, dams, related equipment and pipelines, and other facilities used to furnish water for domestic, industrial, irrigation, or other purposes.

(3) *Effective date.* The provisions of this paragraph apply in the case of facilities provided by obligations issued after January 1, 1969. In the case of facilities provided by obligations issued on or before such date to which section 103(b) is applicable, the provisions of paragraph (f) of this section shall apply. For such purposes, wherever the term "local furnishing of electric energy or gas" appears in paragraph (f) of this section, such term shall be deemed to read "local furnishing of electric energy, gas, or water."

(i) *Examples.* The application of section 103(c)(4) and this section are illustrated by the following examples:

Example (1). City A plans to issue $10 million of bonds to be used to finance the construction of residential housing for family units to be available to members of the general public. It enters into an agreement with corporation X whereby X will lease and operate the facility for 25 years, and the lease payments and the property itself will be the security for the payment of principal and interest on the bonds. Corporation X has an option to purchase the facility at the end of the 25-year period. The bonds are industrial development bonds, but because the proceeds are to be used for construction of residential housing for family units which is an exempt facility under section 103(c)(4)(A) and paragraph (b) of this section, section 103(c)(1) does not apply unless the provisions of section 103(b)(8) and § 1.103-11 apply.

Example (2). The facts are the same as in example (1), except that the facility is constructed adjacent to a factory owned by X, which is in an industrial area, and X reserves the privilege of giving preference to its employees in selecting tenants. The bonds are industrial development bonds and the facility is not an exempt facility under section 103(c)(4)(A) and paragraph (b) of this section because it is not a facility constructed for use by the general public.

Example (3). City B plans to issue $10 million of bonds to be used to construct a sports stadium. The revenues from the facility and the facility itself will be the security for the bonds. A professional football team rents the facility on a long-term leasee for part of the year and a professional baseball team rents the sports facility for the remainder of the year. Tickets are sold by the teams to the general public. The bonds are industrial development bonds, but since the proceeds are used for a spectator facility for general public use, which is an exempt facility under section 103(c)(4)(B) and paragraph (c) of this section, section 103(c)(1) does not apply unless the provisions of section 103(b)(8) and § 1.103-11 apply.

Example (4). City C plans to issue $10 million of bonds to be used to construct a convention hall which it will own. City C plans to lease the convention hall for 25 years to corporation Y, a nonexempt person, which will operate and maintain it. The terms of the lease obligate Y to make the convention hall generally available for civic, business, and recreational shows, meetings, performances, and similar activities serving or benefiting the community. Lease payments from Y and the facility will be security for the bonds. The bonds are industrial development bonds, but since the proceeds are to be used for a facility for general public use, which is an exempt facility under section 103(c)(4)(C) and paragraph (d) of this section, section 103(c)(1) does not apply unless the provisions of section 103(b)(8) and § 1.103-11 apply.

Example (5). City D issues $100 million of its bonds and uses the proceeds to finance

construction of an airport for the use of the general public. D will own and operate the airport. A major portion of the rentable space in the terminal building is leased on a long-term basis to common carrier and nonscheduled airlines. The bonds will be secured by the airport landing and runway charges and by payments with respect to such long-term leases from such commercial airlines. Such commercial airline payments are expected to constitute more than 50 percent of the total revenues from the airport. The bonds are industrial development bonds, but since the proceeds are to be used for an airport for use by the general public and by carriers serving the general public, which is an exempt facility under section 103(c)(4)(D) and paragraph (e) of this section, section 103(c)(1) does not apply unless the provisions of section 103(b)(8) and § 1.103-11 apply. The result would be the same if D hired an airport management firm to operate the airport.

Example (6). City E issues $6 million of its bonds and uses the proceeds to finance construction of a landing strip for airplanes to be located adjacent to the factories of corporations Y and Z. The landing strip will be used in the trades or businesses of Y and Z and by any member of the general public wishing to use it. However, due to its location, general public use will be negligible. The lease payments by Y and Z for the use of the facility are the security for the bonds. The bonds are industrial development bonds and the facility is not an exempt facility under section 103(c)(4)(D) and paragraph (c) of this section because it is not a facility constructed for general public use.

Example (7). State F and corporation Z enter into an arrangement which provides that F will issue $10 million of its bonds and use the proceeds to construct a facility for Z the only purpose of which is to control air and water pollution at Z's plant. The principal and interest on the bonds will be secured by the charges which F will impose on Z. The bonds are industrial development bonds, but since the proceeds are to be used for air and water pollution facilities designed to abate pollution by private persons, such facilities are for the benefit of the general public and are exempt facilities under section 103(c)(4)(F) and paragraph (g) of this section. Accordingly, section 103(c)(1) does not apply unless the provisions of section 103(b)(8) and § 1.103-11 apply.

Example (8). City G issues $20 million of its bonds and will use $6 million to finance construction of residential real property for family units which qualifies as an exempt facility under section 103(c)(4)(A) and paragraph (b) of this section, $9 million to finance construction of a stadium which qualifies as an exempt facility under section 103(c)(4)(B) and paragraph (c) of this section, and $5 million for convention facilities which qualify as exempt facilities under section 103(b)(4)(C) and paragraph (d) of this section. The facilities will be used in the trades or businesses of nonexempt persons and rental payments with respect to such facilities and the facilities themselves will be the security for the bonds. The bonds are industrial development bonds, but since all the proceeds are to be used for facilities which are exempt facilities under section 103(c)(4), section 103(c)(1) doe not apply unless the provisions of section 103(b)(8) and § 1.103-11 apply. The result would be the same if, instead of using $9 million to finance construction of a stadium, the $9 million were used to finance construction of a Capitol building.

[T.D. 7199, 37 FR 15490, Aug. 3, 1972; 37 FR 16177, Aug. 11, 1972; 37 FR 17826, Sept. 1, 1972, as amended by T.D. 7362, 40 FR 26028, June 20, 1975; T.D. 7511, 42 FR 54285, Oct. 5, 1977; T.D. 7737, 45 FR 75645, Nov. 17, 1980]

§ 1.103-9 Interest on bonds to finance industrial parks.

(a) *General rule.* (1) Under section 103(c)(5), interest paid on an issue of obligations issued by a State or local governmental unit (as defined in § 1.103-1) is not includable in gross income if substantially all of the proceeds of such issue is to be used to finance the acquisition or development of land as the site for an industrial park (referred to in this section as "industrial park bonds"). However, interest on an obligation of such an issue is includable in gross income if the obligation is held by a substantial user or a related person (as described in section 103(c)(7) and § 1.103-11). If substantially all of the proceeds of a bond issue is to be so used to finance an industrial park, the debt obligations are treated as obligations described in section 103(a)(1) and § 1.103-1 even though such obligations are industrial development bonds within the meaning of section 103(c)(2) and § 1.103-7. Whether substantially all of the proceeds of an issue of governmental obligations are used to finance an industrial park is determined consistently with the rules for exempt facilities in § 1.103-8(a)(1)(i).

(2) The provisions of subparagraph (1) of this paragraph shall also apply to an issue of obligations substantially all of the proceeds of which is to be

used to acquire or develop land as the site for an industrial park described in section 103(c)(5) and this section and for either or both of the following purposes: (i) To finance exempt facilities described in section 103(c)(4) and § 1.103–8, (ii) to finance facilities to be used by an exempt person.

(3) Section 103(c)(5) only becomes applicable where the bond issue meets both the trade or business and the security interest tests so that the obligations are industrial development bonds within the meaning of section 103(c)(2). For the interrelationship of the rules provided in this section and the exemption for certain small issues provided in section 103(c)(6), see § 1.103–10.

(b) *Definition of an industrial park.* For purposes of section 103(c)(5) and this section, the term "industrial park" means a tract of land, other than a tract of land intended for use by a single enterprise, suitable primarily for use as building sites by a group of enterprises engaged in industrial, distribution, or wholesale businesses if either—

(1) The control and administration of the tract is vested in an exempt person (within the meaning of paragraph (b)(2) of § 1.103–7), or

(2) The uses of the tract are normally (i) regulated by protective minimum restrictions, ordinarily including the size of individual sites, parking and loading regulations, and building setback lines, and (ii) designed to be compatible, under a comprehensive plan, with the community in which the industrial park is located and with the uses of the surrounding land.

(c) *Development of land defined.* For purposes of section 103(c)(5) and this section, the term "development of land" includes the provision of certain improvements to an industrial park site if such improvements are incidental to the use of the land as an industrial park. Such incidental improvements include the building or installation of incidental water, sewer, sewage and waste disposal, drainage, or similar facilities (whether surface, subsurface, or both). Such incidental improvements include the provision of incidental transportation facilities, such as hard-surface roads (including curbs and gutters) and railroad spurs and sidings; power distribution facilities, such as gas and electric lines; and communication facilities. The provision of structures or buildings of any kind is not included within the meaning of the term "development of land," except for those structures or buildings which are necessary in connection with the incidental improvements encompassed by the term, such as, for example, a water pumphouse and storage tank needed in connection with the incidental provision of water facilities in an industrial park.

(d) *Examples.* The application of the rules contained in section 103(c)(5) and this section are illustrated by the following examples:

Example (1). City A and corporations X, Y, and Z (unrelated companies) enter into an arrangement under which A is to acquire a tract of land suitable for use as an industrial park. The arrangement provides that: (1) A will issue $10 million of bonds to be used for the acquisition and development of a suitable tract of land; (2) the tract will be controlled and administered by A, pursuant to a comprehensive zoning plan, for the use of a group of enterprises; (3) A will install necessary water, sewer, and drainage facilities on the tract; (4) A will sell substantial portions of the developed tract to X for use as a factory site and to Y for use as a warehouse site; (5) A will lease a sizeable portion of the tract to Z for 20 years as a distribution center site; and (6) the developed tract and the proceeds from the sale or lease of parts of the tract will be the security for the bonds. The bonds are industrial development bonds. Since, however, the proceeds of the issue are to be used for the acquisition and development of a tract of land as the site for an industrial park under section 103(c)(5), section 103(c)(1) does not apply unless the provisions of section 103(c)(7) and § 1.103–11 apply.

Example (2). The facts are the same as in example (1) except that $1 million of the proceeds of the $10 million issue are to be used for the construction of a factory by corporation W or X. The bonds are industrial development bonds. Under these circumstances, substantially all of the proceeds are treated as used or to be used for the acquisition and development of a tract of land as the site for an industrial park described in section 103(c)(5). Accordingly, section 103(c)(1) does not apply unless the provisions of section 103(c)(7) and § 1.103–11 apply.

[T.D. 7199, 37 FR 15494, Aug. 3, 1972, as amended by T.D. 7511, 42 FR 54285, Oct. 5, 1977]

§ 1.103-10 Exemption for certain small issues of industrial development bonds.

(a) *In general.* Section 103(c)(6) applies to certain industrial development bond issues (referred to in this section as "exempt small issues") and bonds issued to refund certain issues (referred to in this section as "exempt small refunding issues"). If an issue is an exempt small issue or an exempt small refunding issue, then under the requirements of section 103(c)(6) and this section the interest paid on the debt obligations is not includable in gross income, and the obligations are treated as obligations described in section 103(a)(1) and § 1.103-1, even though such obligations are industrial development bonds as defined in section 103(c)(2) and § 1.103-7. However, interest on an obligation of such an issue is includable in gross income if the obligation is held by a substantial user of the financed facilities or a related person (as described in section 103(c)(7) and § 1.103-11). Section 103(c)(6) only becomes applicable where the bond issue meets both the trade or business and the security interest tests so that the obligations are industrial development bonds within the meaning of section 103(c)(2).

(b) *Small issue exemption*—(1) *$1 million or less.* Section 103(c)(6)(A) provides that section 103(c)(1) shall not apply to any debt obligation issued by a State or local governmental unit as part of an issue where—

(i) The aggregate authorized face amount of such issue (determined by aggregating the outstanding face amount of any prior exempt small issues described in paragraph (d) of this section and the face amount of the issue of obligations in question) is $1 million or less; and

(ii) Substantially all of the proceeds of such issue is to be used for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation under section 167. Proceeds which are loaned to a borrower for use as working capital or to finance inventory are not used in the manner described in the preceding sentence. Whether substantially all of the proceeds of an issue of governmental obligations are used in such manner is determined consistently with the rules for exempt facilities in § 1.103-8(a)(1)(i). Any obligation which is an industrial development bond within the meaning of section 103(c)(2) and which satisfies the $1 million small issue exemption requirements is an exempt small issue. See paragraph (c)(1) of this section for the treatment of refunding issues of $1 million or less.

(2) *$5 million or less.* (i) Under section 103(c)(6)(D), the issuing State or local governmental unit may elect to have an aggregate authorized face amount of $5 million or less, in lieu of the $1 million exemption otherwise provided for in section 103(c)(6)(A), with respect to issues of obligations which are industrial development bonds (within the meaning of section 103(c)(2)) issued after October 24, 1968. If such election is made, the bonds will be treated as obligations of a State or local governmental unit described in section 103(a)(1) and § 1.103-1 if the sum of—

(*a*) The aggregate face amount of the issue including the aggregate face amount of any prior outstanding $1 million or $5 million exempt small issues taken into account under section 103(c)(6)(B) and paragraph (d) of this section, and

(*b*) The aggregate amount of "section 103(c)(6)(D) capital expenditures" (within the meaning of subdivision (ii) of this subparagraph)

is $5 million or less. In the case of an issue of obligations which qualified for exemption under section 103(c)(6)(A) and this paragraph, if a section 103(c)(6)(D) capital expenditure made after the date of issue has the effect of making taxable the interest on such issue, under section 103(c)(6)(G) the loss of tax exemption for such interest shall begin only with the date on which the expenditure which caused the issue to cease to qualify under the $5 million limit was paid or incurred. See subdivision (vi) of this subparagraph for the time, place, and manner by which the issuer may elect the $5

million exemption. See section 103(c)(6)(H) and paragraph (c)(2) of this section for the treatment of certain refinancing issues of $5 million or less.

(ii) The term "section 103(c)(6)(D) capital expenditure" is defined in this subdivision. Special rules for applying such definition in the case of certain expenditures paid or incurred by a State or local governmental unit are prescribed in subdivision (iii) of this subparagraph. Except as excluded by subdivision (iv) or (v) of this subparagraph, an expenditure (regardless of how paid, whether in cash, notes, or stock in a taxable or nontaxable transaction) is a section 103(c)(6)(D) capital expenditure if—

(*a*) The capital expenditure was financed other than out of the proceeds of issues taken into account under subdivision (i)(*a*) of this subparagraph,

(*b*) The capital expenditures were paid or incurred during the 6-year period which begins 3 years before the date of issuance of the issue in question and ends 3 years after such date,

(*c*) The principal user of the facility in connection with which the property resulting from the capital expenditures is used and the principal user of the facility financed by the proceeds of the issue in question is the same person or are two or more related persons (as defined in section 103(c)(6)(C) and paragraph (e) of this section),

(*d*) Both facilities referred to in (*c*) of this subdivision were (during the period described in (*b*) of this subdivision or a part thereof) located in the same incorporated municipality or in the same county outside of the incorporated municipalities in such county), and

(*e*) The capital expenditures were properly chargeable to the capital account of any person or State or local governmental unit (whether or not such person is the principal user of the facility or a related person) determined, for this purpose, without regard to any rule of the Code which permits expenditures properly chargeable to capital account to be treated as current expenses. With respect to obligations issued on or after August 8, 1972, determinations under the preceding sentence shall be made by including any expenditure which may, under any rule or election under the Code, be treated as a capital expenditure (whether or not such expenditure is so treated). With respect to obligations issued on or after August 8, 1972, for purposes of this subparagraph, capital expenditures made with respect to a contiguous or integrated facility which is located on both sides of a border between two or more political jurisdictions are made with respect to a facility located in all such jurisdictions and, therefore, shall be treated as if they were made in each such political jurisdiction.

(iii) Amounts properly chargeable to capital account under subdivision (ii)(*e*) of this subparagraph include capital expenditures made by a State or local governmental unit with respect to an exempt facility or an industrial park, within the 6-year period described in subdivision (ii)(*b*) of this subparagraph, out of the proceeds of bond issues to which section 103(c)(1) did not apply by reason of section 103(c) (4) or (5) (relating to certain exempt activities and industrial parks). Thus, for example, the cost to the lessor of a leased plantsite financed out of the proceeds of an issue for an exempt air pollution control facility under section 103(c)(4)(F) and paragraph (g) of § 1.103-8 would constitute a section 103(c)(6)(D) capital expenditure. However, in the case of an industrial park, only the land costs allocated on an area basis to the plantsite and the actual cost of any improvements made on the plantsite, or to be used principally in connection with the actual plantsite occupied by a principal user or a related person, shall be taken into account as capital expenditures. Where the actual amount of capital expenditures made with respect to a facility by a person (including a State or local governmental unit) other than the user of such facility (or a related person) cannot be ascertained, the fair market value of the property with respect to which the capital expenditures were made, at the time of such capital expenditures, shall be deemed to be the amount of such capital expenditures. In the case of a transaction which is not in form a purchase but which is treated as a pur-

chase for Federal income tax purposes, the purchase price for Federal income tax purposes shall constitute a capital expenditure.

(iv) A section 103(c)(6)(D) capital expenditure shall not include any "excluded expenditure" described in (*a*) through (*e*) of this subdivision (iv).

(*a*) A capital expenditure is an excluded expenditure if either it is made by a public utility company which is not the principal user of the facility financed by the proceeds of the issue in question (or a related person) with respect to property of such company, or it is made by a State or local governmental unit with respect to property of such unit, and if in either case it meets all of the following three conditions: Such property of such company or unit (as the case may be) must be used to provide gas, water, sewage disposal services, electric energy, or telephone service. Such property must be installed in, or connected to, the facility but must not consist of property which is such an integral part of the facility that the cost of such property is ordinarily included as part of the acquisition, construction, or reconstruction cost of such facility. Such property must be of a type normally paid for by the user (or a related person) in the form of periodic fees based upon time or use.

(*b*) A capital expenditure is an excluded expenditure if it is made by a person other than the user, a related person, or a State or local governmental unit and if it is made with respect to tangible personal property (within the meaning of paragraph (c) of § 1.48-1), or intangible personal property, leased to the user (or a related person) of a facility. However, the preceding sentence shall apply only if such personal property is leased by the manufacturer of such tangible or intangible personal property, or by a person in the trade or business of leasing property the same as, or similar to, such personal property, and only if, pursuant to general business practice, property of such type is ordinarily the subject of a lease.

(*c*) A capital expenditure is an excluded expenditure if it is made to replace property damaged or destroyed by fire, storm, or other casualty, to the extent that these expenditures do not exceed in dollar amount the fair market value (determined immediately before the casualty) of the property replaced.

(*d*) A capital expenditure is an excluded expenditure if it is required by a change made after the date of issue in a Federal or State law, or a local ordinance which has general application, or if it is required by a change made after such date in rules and regulations of general application issued under such law or ordinance.

(*e*) A capital expenditure is an excluded expenditure if it is required by or arises out of circumstances which could not reasonably be foreseen on the date of issue or which arise out of a mistake of law or fact. However, the aggregate dollar amount taken into account under this subdivision (*e*) with respect to any issue may not exceed $1 million. With respect to expenditures incurred prior to December 11, 1971, the dollar amount specified in the preceding sentence shall be $250,000.

(v) (*a*) If the assets of a corporation are acquired by another corporation in a transaction to which section 381(a) (relating to carryovers in certain corporate acquisitions) applies, the exchange of consideration by the acquiring corporation for such assets is not a section 103(c)(6)(D) capital expenditure by such acquiring corporation.

(*b*) However, if an exchange referred to in (*a*) of this subdivision occurs during the 6-year period beginning 3 years before the date of issuance of an issue of obligations and ending 3 years after such date, the transferor and transferee shall be treated as having been related persons for the portion of such 6-year period preceding the date of the exchange for purposes of determining whether section 103(c)(6)(D) capital expenditures have been made. For purposes of this subdivision (*b*), the date of an exchange to which section 381 applies shall be the date of distribution or transfer within the meaning of paragraph (b) of § 1.381(b)-1.

(*c*) If section 351(a) applies to a transfer of property to a corporation solely in exchange for its stock or securities, the issuance of such stock or securities in such exchange is not a

section 103(c)(6)(D) capital expenditure by such corporation.

(*d*) However, if such a transfer referred to in (*c*) of this subdivision occurs during the 6-year period beginning 3 years before the date of issuance of an issue of obligations and ending 3 years after such date, and if, with respect to the property transferred, expenditures made within such period would have been section 103(c)(6)(D) capital expenditures if the transferor and transferee had been related persons for such period, then such expenditures shall be considered to be section 103(c)(6)(D) capital expenditures made by the transferee. In addition, if a transferor and transferee are related persons immediately following such transfer, such transferor and transferee shall also be treated as having been related persons for the portion of such 6-year period preceding the date of such transfer.

(*e*) For purposes of this subdivision (v), the term "issue of obligations" means an issue being tested for purposes of qualifying or continuing to qualify under an election pursuant to section 103(c)(6)(D) as to which an amount which would be a section 103(c)(6)(D) capital expenditure solely by reason of (*b*) or (*d*) of this subdivision must be taken into account.

(*f*) If with respect to an issue of obligations an expenditure would not have been a section 103(c)(6)(D) capital expenditure but for the application of (*b*) or (*d*) of this subdivision, and if such section 103(c)(6)(D) capital expenditure has the effect of making taxable the interest on an issue of obligations which qualified for exemption under section 103(c)(6)(A) and this paragraph, the loss of tax exemption for such interest shall begin not earlier than the date of such exchange or transfer referred to in this subdivision (v).

(vi) (*a*) The issuer may make the election provided by section 103(c)(6)(D) and this subparagraph (assuming that the bonds otherwise qualify under section 103(c)(6)) by means of a statement signed by a duly authorized official that the governmental unit elects to have the provisions as to the $5 million limit in section 103(c)(6)(D) apply to an issue of industrial development bonds. The statement shall be filed prior to the issuance of such industrial development bonds, or if, not previously filed, within 90 days after June 5, 1971, with the district director or director of the regional service center with whom the principal user or users of the proceeds of such issue, or facilities acquired, constructed, reconstructed, or improved with the proceeds of such issue, are required to file their income tax returns (as provided in section 6091) for the taxable year during which the election is made. A copy of such statement shall be attached to the income tax returns of such principal users for such taxable year.

(*b*) The statement shall contain the following information:

(*1*) The name and address of the governmental unit,

(*2*) The name, address, and employer identification number of the principal user or users of such proceeds or facilities,

(*3*) The date and face amount of the issue,

(*4*) The date and amount of any outstanding issues the proceeds of which have been or will be used primarily with respect to facilities the principal user or users of which are or will be the same or related persons as those listed in (*2*) of this subdivision (vi) (*b*) and which are located in the same incorporated municipality or in the same county (outside of the incorporated municipalities in such county), and

(*5*) The date and amount of any section 103(c)(6)(D) capital expenditures paid or incurred within the 3 years preceding the date of the issue for which the election is made with respect to facilities described in (*4*) of this subdivision (vi) (*b*).

(*c*) Each principal user shall also file a supplemental statement which lists by date and amount any subsequent section 103(c)(6)(D) capital expenditures. Such supplemental statement must be filed with the district director or director of the regional service center with whom the user's income tax return is required to be filed (as prescribed in section 6091) on the due date prescribed for filing such return

(without regard to any extensions of time).

(c) *Refunding or refinancing issue exemption* —(1) *$1 million or less refunding issue.* Section 103(c)(6)(A) also provides that section 103(c)(1) shall not apply to any debt obligation issued by a State or local governmental unit as part of an issue the aggregate authorized face amount of which is $1 million or less, if substantially all of the proceeds of such issue are to be used—

(i) To redeem part of all of a prior issue substantially all of the proceeds of which were used to acquire, construct, reconstruct, or improve land or property of a character subject to the allowance for depreciation, or

(ii) To redeem part or all of a prior exempt small refunding issue.

(2) *$5 million or less refinancing issue.* Section 103(c)(6)(H) provides that section 103(c)(1) shall not apply to any debt obligation issued by a governmental unit as part of an issue which is $5 million or less if the condition of section 103(c)(6)(H) is met and if substantially all of the proceeds are to be used—

(i) To redeem part or all of one or more prior exempt small issues, or

(ii) To redeem part or all of one or more prior exempt small refunding issues.

The condition of section 103(c)(6)(H) is that an election by the issuer of the $5 million exemption in lieu of the $1 million limit for a refunding issue may be made only if each prior issue being redeemed is an issue which qualified either for the $1 million exemption or, by reason of an election under section 103(c)(6)(D), for the $5 million exemption. In addition, in applying the capital expenditures test under section 103(c)(6)(D)(ii) and paragraph (b)(2)(i)(*b*) of this section to refinancing issues, section 103(c)(6)(D) capital expenditures are taken into account only for purposes of determining whether prior issues which were made under the section 103(c)(6)(D) election qualified under section 103(c)(6)(A) and would have continued to qualify under that section but for the redemption.

(d) *Certain prior issues taken into account*—(1) *In general.* Section 103(c)(6)(B) provides, in effect, that if (i) a prior issue specified in subparagraph (2) of this paragraph is an exempt small issue (including for this purpose an exempt small refunding issue) under section 103(c)(6)(A) and this section, and (ii) such prior issue is outstanding at the time of issuance of a subsequent issue, then in determining the aggregate face amount of such subsequent issue (for purposes of determining whether such issue is a $1 million or $5 million exempt small issue under section 103(c)(6)(A) and this section) there shall be taken into account the outstanding face amount of such prior exempt small issue. For purposes of this paragraph, the outstanding face amount of a prior exempt small issue does not include the face amount of any obligation which is to be redeemed from the proceeds of such subsequent issue.

(2) *Prior issues specified.* The face amount of an outstanding prior exempt small issue is taken into account under subparagraph (1) of this paragraph if—

(i) The proceeds of both the prior exempt small issue and of the subsequent issue (whether or not the State or local governmental unit issuing such obligation is the same unit for each such issue) are or will be used primarily with respect to facilities located or to be located in the same incorporated municipality or located or to be located in the same county outside of an incorporated municipality in such county (and, for purposes of this subdivision, on or after August 8, 1972, a contiguous or integrated facility which is located on both sides of a border between two or more political jurisdictions shall be treated as if it is entirely within each such political jurisdiction), and

(ii) The principal user of the financed facilities referred to in subdivision (i) of this subparagraph is or will be the same person or two or more related persons (as defined in section 103(c)(6)(C) and paragraph (e) of this section).

(3) *Rules of application.* The rules of this paragraph shall apply—

(i) Only in the case of outstanding prior exempt small issues which are industrial development bonds to which

section 103(c)(1) would have applied but for the provisions of section 103(c)(6). Thus, for example, the provisions of this paragraph do not apply in respect of a prior issue of obligations issued on or before April 30, 1968. In addition, the provisions of this paragraph do not apply in respect of a prior issue for an exempt facility under section 103(c)(4) and § 1.103–8, or for an industrial park under section 103(c)(5) and § 1.103–9, whether or not the issue might also have qualified as an exempt small issue under section 103(c)(6)(A) and this section.

(ii) To all prior exempt small issues which meet the requirements of this paragraph. Thus, for example, in determining the aggregate face amount of an issue under section 103(c)(6)(A), the outstanding face amount of prior $1 million or $5 million exempt small issues which meet the requirements of this paragraph shall be taken into account in determining the aggregate face amount of a subsequent issue being tested for the $1 million small issue exemption. Similarly, in determining the aggregate face amount of an issue under section 103(c)(6)(A) and (D), the outstanding face amount of prior $1 million or $5 million exempt small issues which meet the requirements of this paragraph shall be taken into account in determining the aggregate face amount of a subsequent issue being tested for the $5 million small issue exemption.

(e) *Related persons.* For purposes of section 103(c) and §§ 1.103–7 through 1.103–11, the term "related person" means a person who is related to another person if, on the date of issue of an issue of obligations—

(1) The relationship between such persons would result in a disallowance of losses under section 267 (relating to disallowance of losses, etc., between related taxpayers) and section 707(b) (relating to losses disallowed, etc., between partners and controlled partnerships) and the regulations thereunder, or

(2) Such persons are members of the same controlled group of corporations, as defined in section 1563(a), relating to definition of controlled group of corporations (except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a)) and the regulations thereunder.

(f) *Examples.* The application of the rules contained in section 103(c)(6) and this section are illustrated by the following examples:

Example (1). County A and corporation X enter into an arrangement under which the county will provide a factory which X will lease for 25 years. The arrangement provides (1) that A will issue $1 million of bonds on March 1, 1970, (2) that the proceeds of the bond issue will be used to acquire land in County A (but not in an incorporated municipality) and to construct and equip a factory on such land in accordance with X's specifications, (3) that X will rent the facility for 25 years at an annual rental equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds, and (4) that such payments by X and the facility itself shall be the security for the bonds. Although the bonds issued are industrial development bonds, the bonds are an exempt small issue under section 103(c)(6)(A) and this section since the aggregate authorized face amount of the bond issue is $1 million or less and all of the proceeds of the bond issue are to be used to acquire and improve land and acquire and construct depreciable property. The result would be the same if the arrangement provided that X would purchase the facility from A.

Example (2). The facts are the same as in example (1) except that, instead of acquiring land and constructing a new factory, the arrangement provides that A will acquire a vacant existing factory building and rebuild and equip the building in accordance with X's specifications. The bonds are an exempt small issue for the same reasons as in example (1).

Example (3). The facts are the same as in example (1) or (2) except that the financed facilities are additions to facilities which were financed by an issue of bonds to which section 103(c)(1) does not apply because such bonds were issued prior to May 1, 1968, or were subject to the transitional provisions of § 1.103–12. The bonds are an exempt small issue since neither of the prior bond issues are taken into account under section 103(c)(6)(B) and this section in determining the status of industrial development bonds which are issued after April 30, 1968, and which are not subject to the transitional provisions of § 1.103–12.

Example (4). The facts are the same as in example (1) except that, subsequently, corporation X proposes to County A that A build a $400,000 warehouse located in Town M (an unincorporated town located in

County A) for X under terms similar to the factory arrangement described in example (1). On the proposed issue date of the subsequent bond issue, $600,000 of the first exempt small issue will be outstanding. If A issues $400,000 of bonds for such purposes, the bonds will be an exempt small issue under section 103(c)(6) and this section since, under the rules of section 103(c)(6)(B) and paragraph (d) of this section, if the aggregate authorized face amount of the new issue and the outstanding prior exempt small issue will be $1 million or less, the new issue will be an exempt small issue. If, however, the aggregate authorized face amount of the prior issue outstanding on the date of the subsequent issue were in excess of $600,000, the subsequent issue would not qualify as an exempt small issue because (1) the combined aggregate face amount of the outstanding prior issue and the new issue would be in excess of $1 million, (2) the facilities financed by both issues are to be located in unincorporated areas in the same county, (3) the same taxpayer will be the principal user of both facilities, and (4) but for the rules of section 103(c)(6)(B) and paragraph (d) of this section the prior issue would be an exempt small issue.

Example (5). The facts are the same as in example (1) except that subsequently corporation X proposes to City P and City R (incorporated municipalities located in County A) that P and R each issue bonds and each build $1 million facilities to be located in Cities P and R for the use of X under terms similar to the arrangement in example (1). Each of the $1 million issues will be an exempt small issue because each proposed facility is located within a different incorporated municipality and the proceeds of the prior outstanding exempt small issue were used to construct facilities outside of an incorporated area.

Example (6). The facts are the same as in example (1) except that $95,000 of the $1 million will be used by the corporation as working capital. The bonds are an exempt small issue for the same reason as in example (1) since substantially all of the proceeds will be used for the acquisition of land and the construction of depreciable property.

Example (7). The facts are the same as in example (1) except that on November 1, 1969, County A issued $10 million of industrial development bonds, all of the proceeds of which were issued for the acquisition of land as the site for an industrial park within the meaning of section 103(c)(5) and § 1.103-9. The proceeds of the $1 million of bonds issued in 1970 will be used to construct a factory for corporation X to be located in the industrial park. The bonds issued in 1970 are industrial development bonds within the meaning of section 103(c)(2) and § 1.103-7. Since, however, the prior 1969 issue is not an issue to which section 103(c)(6)(A) applied (see paragraph (d)(3)(i) of this section), the bonds issued in 1970 are an exempt small issue for the reasons stated in example (1).

Example (8). County B enters into three separate arrangements with three unrelated corporations whereby the county will provide separate storage facilities for each corporation. The arrangement provides (1) that the county will issue bonds and loan to each corporation $250,000 of the proceeds which will be used to acquire land in the county and to construct the facilities, (2) that the rental payments by the corporations will be equal to the amount necessary to amortize the principal and pay the interest on any outstanding bonds issued by the county, and (3) that the payments by the corporations and the facilities themselves shall be the security for the industrial development bonds. For convenience, the county issues one series of bonds in the face amount of $750,000 rather than three separate series of bonds of $250,000 each. The issue is an exempt small issue under section 103(c)(6)(A) and paragraph (b)(1) of this section since the aggregate authorized face amount of the bond issue is $1 million or less, and all of the proceeds of the bond issue are to be used to acquire and improve land and acquire and construct depreciable property.

Example (9). City C and corporation Y enter into an arrangement under which C will provide a factory which Y will lease for 25 years. The arrangement provides (1) that C will issue $4 million of bonds on March 1, 1969, after making the election under section 103(c)(6)(D) and paragraph (b)(2) of this section, (2) that the proceeds of the bond issue will be used to acquire land in the city and to construct and equip a factory on such land in accordance with Y's specifications, (3) that Y will rent the facilities for 25 years at an annual rental equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds, (4) that such payments by Y and the facility itself shall be the security for the bonds, and (5) that, if corporation Y pays or incurs capital expenditures in excess of $1 million within 3 years from the date of issue which disqualify the bonds as an exempt small issue under section 103(c)(6)(D), it will either furnish funds to C to redeem such bonds at par or at a premium, or increase the rental payments to C in an amount sufficient to pay a premium interest rate. Although the bonds issued are industrial development bonds, they are an exempt small issue under section 103(c)(6)(A) by reason of the election under section 103(c)(6)(D) and paragraph (b)(2) of this section, since the aggregate authorized face amount of the bond issue is $5 million or less and all of the proceeds of the bond

issue are to be used to acquire and improve land and acquire and construct depreciable property. The provisions for redemption of the bonds or an increase in rental if the bonds are disqualified as an exempt small issue under section 103(c)(6)(A) will not disqualify an otherwise valid election under section 103(c)(6)(D) and paragraph (b)(2) of this section.

Example (10). The facts are the same as in example (9) except that corporation Y subsequently proposed to the city that it build a $1 million warehouse next to the plant for the use of Y under terms similar to the factory arrangement. Assume further that the factory building was completed by March 1, 1970, and that on January 15, 1972, the proposed issue date of the subsequent bond issue, $2 million of the first exempt small issue will be outstanding. In determining the aggregate authorized face amount of the new issue, the original face amount of a prior outstanding issue must be reduced by that portion which is to be redeemed before it is added to the face amount of the new issue. Therefore, if the city issues $3 million of bonds to redeem the remaining $2 million of bonds and to construct the warehouse the bonds will be an exempt small issue under section 103(c)(6)(A) if an election is made under section 103(c)(6)(D) and paragraph (b)(2) of this section since (1) the face amount of the new issue ($3 million), plus (2) the face amount of the prior outstanding exempt small issue minus the amount of such issue to be refunded ($2 million minus $2 million), plus (3) capital expenditures during the preceding 3 years financed other than out of the proceeds of outstanding issues to which section 103(c)(6)(A) and paragraph (b) of this section applied ($2 million), do not exceed $5 million. If, however, the amount of the January 15, 1972, issue were $3½ million, the issue would not qualify as an exempt small issue under section 103(c)(6)(A) and paragraph (b)(2) of this section.

Example (11). The facts are the same as in example (9), except that on June 15, 1971, Y purchases from an unrelated motor carrier business a warehouse terminal in the same city at a cost of $250,000 and tractor-trailers and other automotive equipment based at the terminal at a cost of $1 million. This subsequent expenditure by Y has the effect of making the interest on the city C bonds includable in the gross income of the holders of such bonds as of June 15, 1971, because the face amount of the March 1, 1969, issue ($4 million) plus the subsequent capital expenditures within 3 years of the date of issue ($1,250,000) exceed $5 million. (See section 103(c)(6)(D) and paragraph (b)(2)(i) of this section.)

Example (12). The facts are the same as in example (9), except that in March, 1970, Y will move $3 million of additional used machinery and equipment into the factory from its factory in another city. The expenditures for such machinery and equipment were incurred by Y more than 3 years prior to the date of issue of the bonds. The transfer of such used equipment into city C does not constitute a section 103(c)(6)(D) capital expenditure within the meaning of paragraph (b)(2)(ii) of this section since the expenditures with respect to such property were incurred more than 3 years prior to the date of issue of the bonds. Had the capital expenditures with respect to such property been incurred during the 6-year period beginning 3 years before the date of issue of the bonds and in the 3 years after such date, they would constitute section 103(c)(6)(D) capital expenditures.

Example (13). The facts are the same as in example (9), except that in March 1970, corporation Y enters into an arrangement with respect to machinery and equipment to be used in the facility. The arrangement is labeled by the parties as a lease but is treated as a sale for Federal income tax purposes. The amount treated as the purchase price of the machinery and equipment is a section 103(c)(6)(D) capital expenditure.

Example (14). On February 1, 1970, city D issues $5 million of its bonds to finance construction of an addition to the manufacturing plant of corporation Z. The bonds will be secured by the facility and lease payments to be made by Z which will be sufficient to pay the principal and interest on such bonds. Assume that the bonds qualify as an exempt small issue under section 103(c)(6)(A) pursuant to an election under section 103(c)(6)(D) and paragraph (b)(2) of this section. On February 1, 1971, D plans to issue $1 million of its bonds to construct a pollution control facility to be leased to Z for use at its manufacturing plant. The rental payments from the lease will be sufficient to pay the principal and interest on the bonds. The bonds will be secured by such facility and the lease payments. Capital expenditures for the pollution control facility will be paid or incurred beginning before February 1, 1973. Although the pollution control facility is an exempt facility under section 103(c)(4)(F) and paragraph (g) of § 1.103-8, amounts used for the pollution control facility shall be considered to be a section 103(c)(6)(D) capital expenditure and the interest on the February 1, 1970, issue will become taxable as of the date such capital expenditure began to be paid or incurred. See section 103(c)(6)(G) and paragraph (b)(2)(i) of this section.

Example (15). On February 1, 1970, City E issues $500,000 of its bonds to acquire and develop an industrial park within the meaning of section 103(c)(5) and paragraph (b) of § 1.103-9. The park consists of 100 acres and is divided into one 50 acre plantsite and 4

smaller sites. The aggregate acquisition cost of the undeveloped land is $150,000 or an average per acre cost of $1,500. Roads, sidewalks, sewers, utilities, sewage, and waste disposal facilities serving the entire industrial park cost $300,000. On September 1, 1970, E leases to corporation Y for 30 years the 50 acre plantsite (with an allocated cost of $75,000) and a railroad spur track from the railroad right of way to Y's plantsite for Y's exclusive use. The spur track was constructed using $50,000 of the proceeds of the industrial park bond issue. E also proposes to issue on September 1, 1970, $4,875,000 of its bonds to construct and equip a building on the leased plantsite to be leased to Y at an additional rental sufficient to pay the principal and interest on this issue of bonds. The September 1, 1970, issue will be an exempt small issue under section 103(c)(6)(A) pursuant to an election under section 103(c)(6)(D) and paragraph (b)(2) of this section since the sum of the amount of the second issue ($4,875,000) and the capital expenditures allocated to the plantsite ($75,000 for 50 acres of land plus $50,000 for the railroad spur tract, totaling $125,000) does not exceed $5 million. The sum of $300,000 which was spent in development of the industrial park provided facilities which will serve or benefit the users generally and hence under paragraph (b)(2)(iii) of this section is not considered to have provided facilities as to which Y will be the principal user.

Example (16). On June 1, 1970, corporation Z simultaneously enters into separate arrangements with City F and City G under which each city will issue a $5 million exempt small issue of bonds the proceeds of which will be used by Z to construct separate facilities in each city. By June 1, 1971, the facilities have been completed in the respective cities. On January 1, 1972, Cities F and G, through a valid legal proceeding, merge into a new City FG. Since in this case F and G were separate cities on June 1, 1970 (the date of the bond issues), the factories are not considered to be located in the same incorporated municipality. Accordingly, each $5 million issue by City F and G will continue to qualify as an exempt small issue.

Example (17). On June 1, 1973, City H issues an exempt small issue of $4.75 million to finance a facility of corporation S to be located in City H. On October 1, 1974, S and corporation T, previously unrelated to S, consummated a statutory merger which qualifies as a reorganization described in section 368(a)(1)(A) and thus as a transaction described in section 381(a). In the transaction, T transferred to S assets with a fair market value of $1.5 million in exchange for stock of S, $300,000 of securities of S, and $100,000 cash. On March 23, 1971, T made $400,000 of capital expenditures for an addition to its factory located in City H. For purposes of testing the H issue of June 1, 1973, such expenditures would have been section 103(c)(6)(D) capital expenditures if T and S had been related persons. Under the provisions of paragraph (b)(2)(v)(a) of this section, the exchange of $1.5 million of stock, securities, and cash by S does not constitute a section 103(c)(6)(D) capital expenditure. Since, however, S and T are treated as related persons starting 3 years prior to the date of issue of the obligations, the $400,000 of expenditures by T constitute section 103(c)(6)(D) capital expenditures. Thus, the interest on the June 1, 1973, issue of obligations would become taxable (since the $5 million limit would be exceeded) on the date of the merger.

Example (18). In 1965 City I issues $10 million of industrial development bonds to construct and equip a factory for corporation Z. In 1975 the remaining principal amount of the bonds outstanding is $4.1 million. If I issues $4.5 million of bonds to redeem the balance of the prior issue, and for other purposes, such issue cannot qualify as an exempt small issue under section 103(c)(6)(D) and paragraph (b)(2) of this section even though at the time of issue the interest on the 1965 bonds was tax-exempt since the prior issue must be one which qualified under section 103(c)(6)(A) and this section. Further, the 1975 issue will be an issue of industrial development bonds notwithstanding the provisions of paragraph (d)(2) of § 1.103-7 which provides that certain bonds issued to refund an issue of obligations issued on or before April 30, 1968 (or January 1, 1969, in certain cases) will not be so treated. Paragraph (d)(2) of § 1.103-7 is not applicable because the 1975 issue makes funds available for a purpose other than the debt service obligation on the 1965 bonds.

Example (19). In 1969 City J issues $4 million of industrial development bonds which qualify as an exempt small issue under section 103(c)(6)(A) pursuant to an election under section 103(c)(6)(D) and paragraph (b)(2) of this section. In 1971, by reason of a $2 million addition to the factory built with the proceeds of the issue, the 1969 exempt small issue loses its tax-exempt status. In 1972, the city issues a $5 million issue to redeem the prior 1969 issue. The redemption issue will not qualify as an exempt small issue since the prior 1969 issue did not continue to qualify under section 103(c)(6)(A) and this section.

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§ 1.103-11 Bonds held by substantial users.

(a) *In general.* Section 103(c) (4), (5), or (6) (relating respectively to interest on bonds to finance certain exempt facilities, interest on bonds to finance industrial parks, and the exemption for certain small issues of industrial development bonds) does not apply, as provided in section 103(c)(7), with respect to any obligation for any period during which such obligation is held either by a person who is a substantial user of the facilities with respect to which the proceeds of such obligation were used or by a related person (within the meaning of section 103(c)(6)(C) and paragraph (e) of § 1.103-10). Therefore, in such a case, interest paid on such an obligation is includable in the gross income of a substantial user (or related person) for any period during which such obligation is held by such user (or related person).

(b) *Substantial user.* In general, a substantial user of a facility includes any nonexempt person who regularly uses a part of such facility in his trade or business. However, unless a facility, or a part thereof, is constructed, reconstructed, or acquired specifically for a nonexempt person or persons, such a nonexempt person shall be considered to be a substantial user of a facility only if (1) the gross revenue derived by such user with respect to such facility is more than 5 percent of the total revenue derived by all users of such facility or (2) the amount of area of the facility occupied by such user is more than 5 percent of the entire usable area of the facility. Under certain facts and circumstances, where a nonexempt person has a contractual or preemptive right to the exclusive use of property or a portion of property, such person may be a substantial user of such property. A substantial user may also be a lessee or sublessee of all or any portion of the facility. A licensee or similar person may also be a substantial user where his use is regular and is not merely a casual, infrequent, or sporadic use of the facility. Absent special circumstances, individuals who are physically present on or in the facility as employees of a substantial user shall not be deemed to be substantial users.

(c) *Examples.* The application of section 103(c)(7) and this section are illustrated by the following examples:

Example (1). Pursuant to an arrangement with corporation X, County A issues $4 million of its bonds (an exempt small issue under section 103(c)(6)(A) pursuant to an election under section 103(c)(6)(D) and paragraph (b)(2) of § 1.103-10) and will use the proceeds to finance construction of a manufacturing facility which is to be leased to X for an annual rental of $500,000. X subleases space to a restaurant operator at an annual rental of $25,000 for the operation of a canteen and lunch counter for the convenience of X's employees. The canteen is required to be open at least 5 days each week (except holidays) from 8:30 a.m. to 5 p.m., and the lunch counter must be in operation during the noon hour. The canteen regularly sells cigarettes, candy, and soft drinks, and uses advertising displays and dispensers with product names. The space physically occupied and the amount of revenue derived by the restaurant operator are more than 5 percent of the respective amounts with respect to the entire facility. Both X and the restaurant operator are substantial users. However, absent special circumstances none of X's employees, the employees of the restaurant operator, or the customers or salesmen who regularly visit the premises to do business either with X or the restaurant operator are substantial users. Similarly, the manufacturers, distributors, and dealers of products sold in the canteen ordinarily are not substantial users.

Example (2). The facts are the same as in example (1) except that X rents food and beverage vending machines from a local dealer. The machines are regularly serviced by the local dealer under a contract with X. Title to and ownership of the machines are retained by the dealer. The local dealer is not deemed to be a substantial user if the revenue derived by such dealer from, and the space occupied by, such machines do not exceed 5 percent of the respective amounts with respect to the entire facility.

Example (3). City B proposes to issue $2 million of bonds which qualify as an exempt small issue under section 103(c)(6)(A) pursuant to an election under section 103(c)(6)(D) and paragraph (b)(2) of § 1.103-10 in order to construct a medical building for certain physicians and dentists. The facility will contain 30 offices to be leased on equal terms and for the same rental rates to each physician or dentist for use in his trade or business. Each physician or dentist will be a substantial user of the facility since the facility is being constructed specifically for such physicians and dentists. The result

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would be the same in the case of an office building for general commercial use.

Example (4). City C proposes to expand the airport it owns and operates with the proceeds of its bonds which qualify as bonds issued for an exempt facility under section 103(c)(4)(D) and paragraph (e) of § 1.103–8 and which are secured by a pledge of airport revenues. The airport is serviced by several commercial airlines which have long-term agreements with C for the use of runways, terminal space, and hangar and storage facilities. Each of the airlines either occupies more than 5 percent of the usable space of, or derives more than 5 percent of the revenue derived with respect to, the airport. C also leases counter and vehicle servicing and parking areas to car rental companies, space for restaurants, kiosks for the sale of newspapers and magazines, and space for the operations of a charter plane company. The latter operates its own planes, offers flying lessons and services, and stores private planes for local businesses and individuals. An airport limousine company has an exclusive franchise for passenger pickup at the terminal. Other taxi, transfer, freight, and express companies regularly deliver passengers and freight to the terminal but do not have space regularly assigned to them, nor do they have operating agreements with C. Various business concerns have advertising product displays in the terminal building. In addition to regular telephone service, coin-operated telephones, provided by the telephone company, are located throughout the terminal, at locations specified by C. None of the above exceed the 5-percent limitations of paragraph (b) of this section and the bond proceeds will not be specifically used for any of them. Only the commercial airlines, which violate the 5-percent limitations, are substantial users of the airport.

Example (5). City D issues $25 million of its revenue bonds and will use $10 million of the proceeds to finance construction of a sports facility which qualifies as an exempt facility under section 103(c)(4)(B) and paragraph (c) of § 1.103–8, $8 million to acquire and develop land as the site for an industrial park within the meaning of section 103(c)(5) and § 1.103–9, and $7 million to finance the construction of an office building to be used exclusively by the city, an exempt person. The revenues from the sports facility and the industrial park and all the facilities themselves will be the security for the bonds. The sports facility and the industrial park sites will be used in the trades of businesses of nonexempt persons. The bonds are industrial development bonds, but under the provisions of paragraph (a)(1) of § 1.103–8 and paragraph (a) of § 1.103–9, the interest on the $25 million issue will not be includable in gross income. However, the interest on bonds held shall be includable in the gross income of a substantial user of either the sports facility or the industrial park if such substantial user holds any of the obligations of the $25 million issue. The 5-percent limitations of paragraph (b) of this section are applied separately with respect to each facility.

Example (6). Authority E issues $4 million of bonds which qualify as an exempt small issue under section 103(c)(6)(A) pursuant to an election under section 103(c)(6)(D) and paragraph (b)(2) of § 1.103–10 in order to construct a bank building on the grounds of an airport. In addition, E issues $40 million to expand the airport. The bank will not derive revenue in excess of 5 percent of the revenue derived with respect to the airport nor will it occupy more than 5 percent of the usable area of such airport. The bank will be a substantial user of the bank building constructed with the proceeds of the $4 million issue since the facility was constructed specifically for the bank. However, the bank will not be a substantial user with respect to the airport because it does not exceed the 5-percent limitations of paragraph (b) of this section. Had E issued one issue of $44 million in order to expand the airport and construct a bank building, the bank would be a substantial user of the entire facility since the $44 million issue was being used to construct a facility a portion of which was specifically for the bank.

[T.D. 7199, 37 FR 15499, Aug. 3, 1972; 37 FR 16177, Aug. 11, 1972]

§ 1.103–12 Transitional provisions.

(a) *In general.* Section 103(c) and §§ 1.103–7 through 1.103–11 do not apply with respect to any obligation issued by a State or local governmental unit before January 1, 1969, if before May 1, 1968, any one of the conditions contained in paragraphs (b) through (e) of this section is satisfied. In addition, the interest paid on obligations described in paragraphs (f) and (g) of this section will not be includable in gross income by reason of the provisions of section 103(c) and §§ 1.103–7 through 1.103–11 if the provisions of those paragraphs are satisfied even though such obligations were issued after January 1, 1969. For purposes of this section, obligations are considered to be issued on the date on which there is a physical delivery of the evidences of indebtedness in exchange for the amount of the issue price. For example, a bond issue is "issued" when the issuer physically exchanges the bonds for the under-

writer's (or other purchaser's) check. Obligations which are taken down after December 31, 1968, by purchasers pursuant to a delayed delivery agreement with the issuer are, therefore, subject to the rules contained in section 103(c) and §§ 1.103–7 to 1.103–11.

(b) *Authorized or approved by State or local governmental unit.* The interest paid on any such industrial development bond is not includable in gross income by reason of section 103(c) and §§ 1.103–7 through 1.103–11 if, before May 1, 1968, the issuance of the obligation (or the project in connection with which the proceeds of the bond issue are to be used) was authorized or approved by the governing body of the unit issuing the obligation or by the voters of such unit. Therefore, if the governing body of the State or local governmental unit issuing industrial development bonds had, prior to May 1, 1968, adopted a resolution or an ordinance which authorized or approved either (1) the project being financed or (2) the bond issue, then the rules of section 103(c) and § 1.103–7 do not apply to the bond issue. A resolution or an ordinance may for example, have, approved a designated project and authorized the later issuance of one or more series of bonds to finance the project. It may have approved the submission of a particular bond issue to the voters for their authorization. Similarly, if prior to May 1, 1968, the voters of a State or local governmental unit have approved the issuance of such bonds for a designated project, section 103(c) is not applicable to the bond issue.

(c) *Significant financial commitment by State or local governmental unit.* The interest paid on any such industrial development bond is not includable in gross income by reason of section 103(c) and §§ 1.103–7 through 1.103–11 if, before May 1, 1968, State or local governmental unit made a significant financial commitment in connection with the issuance of such obligation, with the use of the proceeds to be derived from the sale of such obligation, or with the property to be acquired or improved with such proceeds. The unit making the significant financial commitment with respect to a project financed by the proceeds of an industrial development bond issue need not be the same unit issuing the bonds. For example, a significant financial commitment may be made if a State builds access roads to a project in one of its counties which will issue the bonds. Similarly, if a city or county makes a significant financial commitment to build roads, power lines, or sewer lines to a project within its jurisdiction which is being financed by a separate State or local governmental unit, such as an industrial development board, the condition of this subparagraph is satisfied. For purposes of this subparagraph, the term "significant financial commitment" means the expenditure of (or a commitment to expend) a sizable amount of money. The amount involved need not be compared to the size of the financed project. For example, a commitment to expend $250,000 in connection with a $10 million project would be considered significant.

(d) *Expenditures equal to 20 percent of bond proceeds.* The interest paid on any such industrial development bond is not includable in gross income by reason of section 103(c) and §§ 1.103–7 through 1.103–11 if, before May 1, 1968, any person other than a State or local governmental unit who will use the proceeds to be derived from the sale of such obligation, or who will use the property to be acquired or improved with such proceeds, expended (or entered into a binding contract to expend), for purposes which are related to the use of such proceeds or property, an amount equal to or in excess of 20 percent of such proceeds. A prospective user of the proceeds of an industrial development bond issue, or property to be acquired with such proceeds, will be considered to have entered into a binding contract to expend money for purposes related to the project if (1) such person entered into a contract for fuel, power, water, or raw materials and (2) any conditions to which the obligations of one or more parties to such contract are subject are beyond the control of such parties. For example, a binding contract for alumina entered into in connection with the financing of an aluminum reduction mill or such a con-

tract to purchase timber land in connection with a paper mill are contracts related to the use of the financed facility. For purposes of determining whether the expenditures of the prospective user are equal to or in excess of 20 percent of the bond proceeds, binding contracts will be taken into account on the basis of the amounts to be expended over the term of the contract.

(e) *Approval by economic development agency.* The interest paid on any such industrial development bond is not includable in gross income by reason of section 103(c) and §§ 1.103-7 through 1.103-11 if, before May 1, 1968, in the case of an obligation issued in conjunction with a project where financial assistance will be provided by a governmental agency concerned with economic development, such agency approved the project or an application for financial assistance was pending. For purposes of this subparagraph, the term "financial assistance" includes a guaranty by the agency of the payment of the principal and interest on an obligation by a State, or local governmental unit as well as direct financial aid such as a loan or grant-in-aid made by the unit. For example, section 103(c) and § 1.103-7 do not apply if the Federal Economic Development Administration has approved a grant in connection with a project to be financed by industrial development bonds. Similarly, where a State agency has approved a project and the agency has guaranteed the payment of the principal and interest on the bonds, those rules do not apply. The governmental agency concerned with economic development may be a Federal, State, or local agency. The financial assistance extended need not be directly either to the State or local governmental unit issuing the industrial development bonds or to the person who will use the property acquired or constructed with the bond proceeds. It is sufficient that the assistance extended be in conjunction with a project which includes the property in respect of which the bonds are issued.

(f) *Certain cost overrun issues.* (1) If substantially all of the proceeds of one or more issues of obligations is to be used to finance a cost overrun (within the meaning of subparagraph (2) of this paragraph) on a facility used in the trade or business of a nonexempt person, the provisions of section 103(c) and §§ 1.103-7 through 1.103-11 shall not apply to such cost overrun issue or issues.

(2) For purposes of this paragraph, the term "cost overrun" means the amount necessary to complete a facility, but only if such facility was reasonably expected to be completed with the proceeds of one or more prior issues described in subparagraph (3) of this paragraph, and only if all of the following conditions of this subparagraph are satisfied. Such facility must have been financed with the proceeds of one or more such prior issues in accordance with architectural and engineering plans adopted at the time such prior issue (or the latest prior issue if more than one such prior issue) was issued. The amount of "cost overrun" shall be limited to the amount by which the actual cost of such facility exceeds the reasonably estimated cost of such facility in accordance with such plans at the time that such prior issue (or the latest such prior issue if more than one such prior issue) was issued.

(3) A prior issue of obligations is described in this subparagraph if section 103(c)(1) did not apply to such prior issue because it was issued before May 1, 1968 (or before January 1, 1969, if the transitional provisions of paragraphs (a) through (e) of this section apply to such issue).

(g) *Special rule for certain State or local governmental obligations authorized prior to June 5, 1971.* (1) For purposes of section 103(c) and paragraph (b)(3) of § 1.103-7, the use of 35 percent or less of the proceeds of an issue of obligations described in subparagraph (2) of this paragraph in the trades or businesses of nonexempt persons shall not constitute the use of a major portion of such proceeds in such manner.

(2) An issue of obligations is described in this subparagraph if—

(i) Such issue of obligations was issued prior to June 6, 1971, or

(ii)(*a*) The issuance of such obligations was specifically authorized by an

Act or Ordinance of a State or local governmental unit enacted prior to June 5, 1971.

(*b*) The aggregate face amount of obligations which may be issued pursuant thereto is limited to a specific dollar amount by such Act or Ordinance, and

(*c*) The sum of the aggregate face amount of obligations issued pursuant to such authorization prior to the time of issuance of the issue being tested and the face amount of the issue being tested does not exceed the dollar amount of such limitation in effect on June 5, 1971.

[T.D. 7199, 37 FR 15499, Aug. 3, 1972]

§ 1.103-13 Arbitrage bonds.

(a) *Scope*—(1) *In general.* Under section 103(c)(1), an arbitrage bond shall be treated as an obligation not described in section 103(a)(1) and § 1.103-1. Thus, the interest on an arbitrage bond will be included in gross income and subject to Federal income taxation. In general, arbitrage bonds are obligations issued by a State or local governmental unit, the proceeds of which are reasonably expected to be used to acquire other obligations where the yield on such acquired obligations will be materially higher than the yield on the governmental obligations during the term of such governmental issue. The term "arbitrage bond" is defined in paragraph (b)(1) of this section. Under paragraph (b) of § 1.103-14, the investment of all or a portion of the proceeds of an issue of obligations for a temporary period or periods will not cause such obligations to be arbitrage bonds regardless of the yield produced by such investment. Paragraph (b)(6) of § 1.103-14 provides a temporary period for investment proceeds. Under paragraph (b)(1) of this section, the investment of less than a major portion of the proceeds of the issue in acquired obligations at a materially higher yield will not cause such obligations to be arbitrage bonds. Similarly, under paragraph (d) of § 1.103-14, the investment of a portion of the proceeds as a reasonably required reserve or replacement fund will not cause such obligations to be arbitrage bonds regardless of the yield produced by such investment. Even if an obligation is not an arbitrage bond under section 103(c), such bond may nevertheless be treated as an obligation which is not described in section 103(a)(1) and § 1.103-1 if it is an industrial development bond under section 103(b). For regulations as to special issues of Federal Treasury obligations offered to State and local governmental units, see 31 CFR Part 344.

(2) *Reasonable expectations.* (i) Under section 103(c)(2), the determination whether an obligation is an arbitrage bond depends on the issuer's reasonable expectations, as of the date of issue, regarding the amount and use of the proceeds of the issue. Thus, an obligation is not an arbitrage bond if, based on the issuer's reasonable expectations on the date of issue, the proceeds will not be used in a manner that would cause the obligation to be an arbitrage bond under section 103(c)(2), this section, § 1.103-14, and § 1.103-15. Reasonable expectations as to future events regarding governmental obligations may be established to the extent permitted by the certification described in subdivision (ii) of this subparagraph. For the treatment of certain issues with a face amount of $2,500,000 or less, see subdivision (iii) of this subparagraph.

(ii) (A) A State or local governmental unit may certify, in the bond indenture or a related document, reasonable expectations of the issuer on the date of issue as to future events.

(B) Certification by a State or local governmental unit will not tend to establish conclusions of law (including legal characterizations of future events).

(C) An officer responsible for issuing the bonds must certify for the issuer.

(D) In addition to the matters certified, the certification must set forth (in brief and summary terms) the facts and estimates on which the issuer's expectations are based and state that, to the best of the knowledge and belief of the certifying officer, the issuer's expectations are reasonable.

(E) (*1*) If a temporary period of more than 3 years is allowed under § 1.103-14(b)(5)(ii) (relating to certain construction issues), the issuer must commission an independent architect or engineer to prepare a study of the

planned construction. An architect or engineer will be considered independent if he is not employed by the issuer on a permanent basis.

(*2*) The study prepared by the architect or engineer must accompany the certification and must include an estimated completion date for each stage of the construction.

(F) Subsequent events do not affect a certification made in accordance with this subdivision.

(iii) In the case of an issue with a face amount of $2,500,000 or less, an unqualified opinion of counsel that such obligations are not arbitrage bonds can be conclusively relied upon by the holders of the obligations, if the opinion is reasonable and is not given in bad faith. This subdivision (iii) shall apply only to the first $2,500,000 of governmental obligations issued by (or on behalf of) a State or local governmental unit for the same project in any 12-month period. Thus, for example, if a town issues $2,500,000 of bonds for a school building on July 1, 1980, this subdivision does not apply to additional bonds issued for the same school building before July 1, 1981.

(iv) (A) If a certification contains a material misrepresentation, the Commissioner may disqualify the issuer. The Commissioner will publish notice that the issuer is disqualified in the Internal Revenue Bulletin. The disqualification will not affect bonds issued before the notice is published.

(B) An issuer that is disqualifed may not certify an issue under subdivision (ii) of this subparagraph.

(C) The Commissioner will give an issuer reasonable opportunity to be heard before it is disqualifed.

(D) If appropriate, the Commissioner may requalify an issuer. The Commissioner will publish notice that the issuer has been requalified in the Internal Revenue Bulletin.

(v) The provisions of this subparagraph may be illustrated by the following examples:

Example (*1*). (i) On July 5, 1980, city A issues $3,000,000 of municipal bonds to finance the construction of a water treatment facility. The city includes in the bond indenture a certification which contains a statement that 85 percent of the receipts from the sale of the bonds will be used for construction costs by July 5, 1983.

(ii) Construction of the water treatment facility was determined by the Environmental Protection Agency to have certain adverse effects. Consequently, work on the project was halted and the facility was redesigned to avoid the effects with the result that 85 percent of the receipts from sale of the bonds will not be expended for project costs by July 5, 1983. The certification is conclusive as to the issuer's reasonable expectations that 85 percent of receipts will be expended for construction costs by July 5, 1983.

(iii) Under the circumstances described in subdivision (ii), city A has not made a material misrepresentation in the certification which would permit the Commissioner to disqualify city A under subdivision (iv) of this subparagraph. If, however, city A did not actually expect that 85 percent of the receipts from sale of the bonds would be used for construction costs by July 5, 1983, the certification would contain a material misrepresentation. Under those circumstances, the Commissioner may disqualify city A.

Example (*2*). On January 1, 1980, city A sells $5 million of 6-percent refunding bonds. City A certifies the bonds in the manner described in subdivision (ii) of this subparagraph. In addition, attorney X gives an opinion that the bonds are not arbitrage bonds. In connection with the refunding issue, city A makes use of an artifice or device as described in paragraph (j) of this section. As a result, the legal conslusion reached by attorney X is erroneous and the refunding bonds are arbitrage bonds despite the certification.

Example (*3*). (i) The chairman of the county commission of county X made the following certification with respect to an issue of governmental obligations:

(1) The county is issuing and delivering, simultaneously with the delivery of this certificate, $2,500,000 principal amount of its General Obligation Library Bonds dated December 1, 1988 (herein called "the bonds"). The bonds are being issued for the purpose of providing for payment of a portion of the costs of constructing and equipping a new public library in and for the county.

(2) The estimated total costs of constructing and equipping said library (which is herein called "the library") will be not less than $3,235,000. The said total costs are expected to be financed with (i) $2,500,000 of proceeds from the sale of the bonds, (ii) a Federal grant in the amount of not more than $560,000, and (iii) approximately $151,000 in building funds made available to the county by the county X library board. The county has not yet determined how it will finance the deficiency ($24,000).

(3) The county has heretofore entered into a contract for the construction of the library, which contract obligates the payment by the county of not less than $100,000. The actual work of constructing the library began during the month of September 1988. It is contemplated that such work will proceed with due diligence to completion, expected on or about October 1, 1989.

(4) The county has heretofore expended, for payment of costs incurred in constructing and equipping the library, approximately $758,000, derived from (a) portions of the aforesaid Federal grant, (b) short-term borrowings made in anticipation of the issuance and sale of the bonds and which will be fully repaid within 5 days following the issuance of the bonds, and (c) building funds made available to the county by the county X library board.

(5) The principal proceeds to be derived by the county from the sale of the bonds (excluding the "premium" anticipated to be received by the county from such sale, which premium will, as required by law, be applied to payment of interest maturing with respect to the bonds on June 1, 1989) are expected to be used, needed, and fully expended for payment of costs of constructing and equipping the library (including the repayment of the short-term borrowings referred to in the preceding paragraph (4)) by no later than May 1, 1990.

(6) Except for the debt service fund established under section XII of the bond resolution, the county has not created or established, and does not expect to create or establish, any sinking fund or other similar fund.

(7) To the best of my knowledge, information, and belief, the above expectations are reasonable.

(8) The county has not been notified of any listing of it by the Internal Revenue Service as an issuer that may not certify its bonds.

(9) This certificate is being executed and delivered pursuant to §§ 1.103-13, 1.103-14, and 1.103-15 of the Income Tax Regulations under the Internal Revenue Code of 1954, as amended, and the undersigned chairman of the county commission is one of the officers of the county charged (by resolution and order of the said county commission) with the responsibility of issuing the bonds.

(ii) This certification by county X meets the requirements of subdivision (ii) of this subparagraph and conclusively establishes the county's reasonable expectations on the date of issue as to the future events described in the certification. However, nothing contained in this certification tends to establish any conclusions of law.

Example (4). (i) The chairman of the board of directors and the secretary-treasurer of the industrial development board of city A, a public corporation organized under the laws of State B (herein called "the Industrial Board"), made the following certification:

(1) The Industrial Board is issuing and delivering simultaneously with the delivery of this certificate, its Environmental Improvement Revenue Bonds, 1988 series A dated November 1, 1988, in the principal amount of $6,000,000 (herein called "the bonds"). The bonds are being issued for the purpose of providing funds for the permanent financing of costs of acquiring, constructing, installing and equipping, on certain real property located in county J, the air pollution control facilities described on exhibit A attached hereto and made a part hereto (the said facilities being herein together called "the project facilities"). Those of the project facilities described in paragraph (1) of said exhibit A are herein called "the quench car facilities"; those described in paragraph (2) of said exhibit A, the "sinter line facilities"; and those described in paragraph (3) of said exhibit A, "the mixer fume control facilities."

(2) The project facilities and certain real property (and interests therein) appurtenant thereto are, upon the completion of the acquisition, construction, installation, and equipment of the project facilities, to be sold by the Industrial Board, on an installment basis, to Corporation C, a Delaware corporation (herein called "the corporation"), under and pursuant to an agreement of sale dated as of November 1, 1988 (herein called "the agreement"), between the Industrial Board (as seller) and the corporation (as buyer).

(3) The actual work of acquiring, constructing, installing, and equipping the quench car facilities has, pursuant to the provisions of a letter agreement between the corporation and the Industrial Board (which letter agreement was executed on behalf of the Industrial Board on May 10, 1988, and the corporation on May 11, 1988), heretofore begun and binding contracts or commitments obligating the expenditure, for the work of acquiring, constructing, installing, and equipping the quench car facilities, of not less than $100,000 have heretofore been entered into or made. It is anticipated that the total financeable costs of such acquisition, construction, installation, and equipment (excluding a pro rata portion of (a) interest during construction and (b) the expenses anticipate to be incurred, in connection with the issuance of the bonds) will be approximately $1,231,370. It is expected that the work of acquiring, constructing, installing, and equipping the quench car facilities will proceed with due diligence to full completion, presently anticipated on or about October 1, 1989.

(4) The actual work of acquiring, constructing, installing, and equipping the sinter line facilities has, pursuant to the provisions of a letter agreement between the corporation and the Industrial Board (which letter agreement was executed on behalf of the Industrial Board on May 10, 1988, and on behalf of the corporation on May 11, 1988), heretofore begun, and binding contracts or commitments obligating the expenditure for the work of acquiring, constructing, installing, and equipping the sinter line facilities of not less than $100,000 have heretofore been entered into or made. It is anticipated that the total financeable costs of such acquisition, construction, installation, and equipment (excluding a pro rata portion of (a) interest during construction and (b) the expenses anticipated to be incurred in connection with the issuance of the bonds) will be approximately $1,780,000. It is expected that the work of acquiring, constructing, installing, and equipping the sinter line facilities will proceed with due diligence to full completion, presently anticipated on or about January 1, 1990.

(5) While the actual work of acquiring, constructing, installing, and equipping the mixer fume control has not yet begun, binding contracts or commitments obligating the expenditure for the work of acquiring, constructing, installing, and equipping the mixer fume control facilities of not less than $100,000 have heretofore been entered into or made, and such actual work is expected to begin on or about June 30, 1989. Further, all such work is anticipated to proceed with due diligence thereafter to completion, presently expected on or about September 1, 1990. The total financeable costs of acquiring, constructing, installing, and equipping the mixer fume control facilities (excluding a pro rata portion of (a) interest during construction and (b) the expenses anticipated to be incurred in connection with the issuance of the bonds) are expected to be approximately $2,680,000.

(6) The total proceeds to be received by the Industrial Board on the sale of the bonds, i.e., the gross sum of $5,998,633.33, does not exceed the total of—

(a) The estimated total financeable costs of acquiring, constructing, installing, and equipping the project facilities (excluding (a) interest during construction and (b) the expenses anticipated to be incurred in connection with the issuance of the bonds), viz., the gross sum of $5,691,370, plus

(b) Interest on the bonds during construction of the project facilities and the expenses anticipated to be incurred in connection with the issuance of the bonds, viz., the gross sum of $263,630, plus

(c) The amount required to be set aside out of the proceeds to be derived by the Industrial Board from the sale of the bonds, for payment of a portion of the interest maturing thereon on May 1, 1989, viz., the sum of $43,633.33.

(7) The proceeds to be derived by the Board from the sale of the bonds, viz., the gross sum of $5,998,633.33, are expected to be needed and fully expended as follows:

(a) $43,633.33 of said proceeds will be set aside and paid into the "bond fund" (as said term is used and defined in the trust indenture dated as of November 1, 1988, between the Industrial Board and the First National Bank of A, under which the bonds are being issued) simultaneously with the issuance and delivery of the bonds and used and applied for payment of a portion of the interest maturing thereon on May 1, 1989;

(b) $263,630 of said proceeds will be expended for payment of (i) interest on the bonds during construction of the project facilities, and (ii) the expenses anticipated to be incurred in connection with the issuance of the bonds; and

(c) The remaining $5,691,370 of said proceeds will be expended for payment of the costs of acquiring, construction, equipping, and installing the project facilities (excluding (i) interest on the bonds during construction of the project facilities and (ii) the expenses anticipated to be incurred in connection with the issuance of the bonds) substantially in accordance with the following schedules:

Quarter during which expected to be expended	Amount expected to be expended			Total
	Sinter line	Quench car	Mixer fume control	
1988, Fourth	$280,000			$280,000
1989, First	250,000		$50,000	300,000
1989, Second	430,000	$720,250	350,000	1,500,250
1989, Third	550,000	511,120	800,000	1,861,120
1989, Fourth	270,000		1,150,000	1,420,000
1990, First			300,000	300,000
1990, Second			30,000	30,000
Total	1,780,000	1,231,370	2,680,000	5,691,370

(8) The facts and estimates in paragraphs (2) through (7) are based on representations made by Corporation C. The board is not aware of any facts or circumstances that would cause it to question the accuracy of the representations made by Corporation C.

(9) Money deposited in the debt service fund established by article X of the indenture for the bonds will be used to pay principal of and interest on the bonds and the board reasonably expects that there will be no other funds that will be so used.

(10) Any money deposited in the debt service fund will be spent within a 13-month period beginning on the date of deposit, and any amount received from investment of money held in the debt service fund will be spent within a 1-year period beginning on the date of receipt.

(11) To the best of our knowledge, information, and belief, the above expectations are reasonable.

(12) The Industrial Board has not been notified of any listing of it by the Internal Revenue Service as an issuer that may not certify its bonds.

(13) The undersigned are those officers of the Industrial Board charged, by resolution of the board of directors of the industrial Board, with the responsibility of actually issuing and delivering the bonds.

(ii) This certification by the Industrial Board of city A meets the requirements of subdivision (ii) of this subparagraph and conclusively establishes the board's reasonable expectations on the date of issue as to the future events described in the certification. However, nothing contained in this certification tends to establish any conclusions of law.

(iii) It has been assumed that the letter agreement described in this example constitutes "some other similar official action" within the meaning of § 1.103-8(a)(5).

Example (5). City D issues $10 million of 7-percent revenue bonds for the purpose of constructing a water treatment facility. Certain proceeds of the revenue bonds will be deposited with a trustee. In part, the trust agreement provides as follows: "In the event city D is of the opinion that it is necessary to restrict or limit the yield on the investment of any moneys paid to or held by the trustee hereunder in order to avoid the bonds, or any series thereof, being considered 'arbitrage bonds' within the meaning of the Internal Revenue Code of 1954, as amended, the city may issue to the trustee a written certificate to such effect (along with appropriate written instructions), in which event the trustee will take such action as is necessary so to restrict or limit the yield on such investment in accordance with such certificate and instructions, irrespective of whether the trustee shares such opinion." If city D uses reasonable care in the selection of the trustee, it can reasonably expect the trustee to invest the funds in accordance with the trust agreement. This reasonable expectation will be conclusive without regard to the subsequent actions of the trustee.

Example (6). County Y, in connection with an issue of revenue bonds, covenants in the bond indenture that it will proceed with due diligence to spend the bond proceeds for the construction of a library. This covenant is included in the indenture as a bona fide safeguard for the protection of the bondholders. County Y can reasonably expect to comply with this covenant and, therefore, to satisfy the due diligence test of § 1.103-14(b)(4). The result is the same whether or not the bond proceeds are actually spent with due diligence.

(3) *Innocent mistake.* Bonds are not arbitrage bonds merely because of an inadvertent, insubstantial error (e.g., in arithmetic).

(b) *Definitions.* For purposes of this section, § 1.103-14, and § 1.103-15, the following definitions and rules apply:

(1) *Arbitrage bonds.* (i) Under section 103(c)(2), an obligation is an arbitrage bond if it is issued by a State or local governmental unit as part of an issue of obligations (for purposes of this section, § 1.103-14, and § 1.103-15 referred to as governmental obligations) all or a major portion of the proceeds of which are reasonably expected to be used directly or indirectly—

(A) To acquire acquired obligations which may reasonably be expected, on the date of issue of such governmental obligations, to produce a yield during the term of the issue of such governmental obligations which is materially higher than the yield on such issue, or

(B) To replace funds used directly or indirectly to acquire such obligations (see example (1) of § 1.103-14(e)(7)(ii)).

(ii) A major portion of the proceeds of an issue is any amount which at any time exceeds 15 percent of the original face amount of the issue. If the original proceeds of an issue determined without regard to issuing expenses are less than 98 percent of the original face amount of the issue, the percentage specified in the preceding sentence shall be based on the amount of such original proceeds. See § 1.103-14(e) for special rules that apply to refunding issues. In determining whether acquired obligations allocable to proceeds invested as less than a major

portion at a materially higher yield are so invested, a major portion of the proceeds is invested at a materially higher yield if one or more of such obligations is acquired at a discount or results in interest payments for any annual period in excess of interest payments for any preceding annual period (thus reinvesting annually accrued interest or discount as principal) and if by taking into account the amount of such discount or excess interest (not discounted to present value) ratably each year over the term of such obligation the sum of such amounts plus the purchase price of all obligations allocable to less than a major portion at any time exceeds the amount specified in this paragraph (b)(1)(ii). The term "materially higher" is defined in paragraph (b)(5) of this section. Yield is computed under paragraphs (c) and (d) of this section. For rules with respect to bonds issued to finance certain governmental programs and with respect to exempt arbitrage bonds for educational personnel, see, respectively, paragraphs (h) and (e) of this section. Acquired obligations are defined in paragraph (b)(4) of this section and are allocated under paragraph (f) of this section to proceeds of governmental obligations.

(2) *Proceeds.* The types of proceeds attributable to an issue of governmental obligations are defined and illustrated as follows:

(i) "Original proceeds" are net amounts (after payment of all expenses of issuing the obligations) received by the State or local governmental unit as a result of the sale of such issue. Examples of issuing expenses are advertising and printing costs, financial advisors' and counsel fees, initial fees of trustees, paying agents, certifying or authenticating agents, and similar expenses.

(ii)(A) "Investment proceeds" are amounts received at any time by the issuer, such as interest and dividends, resulting from the investment of any proceeds of an issue of obligations in acquired nonpurpose obligations and amounts received as interest or dividends resulting from the investment of any proceeds of such issue in acquired purpose obligations. Thus, for example, the interest received on acquired Federal obligations purchased with the proceeds of an issue of governmental obligations constitutes investment proceeds of such issue whether or not such acquired obligations represent amounts invested for a temporary period or in a reasonably required reserve or replacement fund under § 1.103-14. Investment proceeds are increased by any profits and decreased (if necessary, below zero) by any losses on such investments. Amounts received from the investment of any proceeds of an issue (other than a refunding issue) are not investment proceeds if, within 1 year of receipt, such amounts are commingled for the purpose of accounting for expenditures with substantial tax or other substantial revenues from operations by a State or local governmental unit.

(B) Despite § 1.103-13(b)(2)(ii)(A), "investment proceeds" do not include receipts from investment of amounts treated as proceeds under § 1.103-13(g) (relating to invested sinking funds).

(3) *State or local governmental unit.* The term "State or local governmental unit" shall have the same meaning as in paragraph (a) of § 1.103-1.

(4) *Acquired obligations.* (i) The term "acquired obligations" means securities and obligations allocated to the proceeds of an issue of governmental obligations during the period of time that such issue is outstanding.

(ii) The term "securities" has the same meaning as in section 165(g)(2)(A) and (B). Thus, the term "security" means (A) a share of stock in a corporation, or (B) a right to subscribe for or to receive a share of stock in a corporation.

(iii) The term "obligation" means any evidence of indebtedness which is not described in section 103(a)(1). Thus, for example, if interest on a bond issued by a State or local governmental unit is not exempt in the hands of the holder because it is an industrial development bond or an arbitrage bond, the bond is an obligation within the meaning of this subdivision. For another example, a transaction which in form is a lease of property by a State or local governmental unit but which is treated for Federal

income tax purposes as a loan (or an installment sale) is an obligation for purposes of this subdivision. Time or demand deposits (whether or not such deposits are interest-bearing) are obligations within the meaning of this subdivision to the extent that such deposit or deposits are maintained for the purposes for which the proceeds of the issue of obligations may be expended (including as a purpose any investment in a reserve or replacement fund). Cash is not an acquired obligation. For example, cash held or received by the trustee of an issue is not taken into account as a zero-yield obligation for the period it is held before being invested in an acquired obligation or for the period that it is held after repayment of an obligation and before being reinvested in an acquired obligation. A contract between the issuer and another person is an acquired obligation if the other person is required under the contract personally (and not in his capacity as trustee or agent) to discharge any obligation of the issuer.

(iv) The classes of acquired obligations and the definitions of such classes are as follows:

(A) "Acquired purpose obligations" are obligations acquired to carry out the purpose of a governmental program for which the governmental obligations are issued. Thus, for example, a note secured by a mortgage on a facility built with the proceeds of an exempt small issue of industrial development bonds (within the meaning of section 103(b)(6) and § 1.103-10) is an acquired purpose obligation in the hands of the issuer of such exempt small issue. Obligations acquired solely for the purpose of realizing an arbitrage profit are not acquired purpose obligations. Acquired obligations acquired with proceeds of a refunding issue that are to be used to discharge the prior issue or that are invested in a reasonably required reserve or replacement fund as less than a major portion are not acquired purpose obligations. However, acquired obligations acquired with transferred proceeds may be acquired purpose obligations if such obligations would have been so treated if the prior issue had not been refunded.

(B) "Acquired nonpurpose obligations" are acquired obligations other than acquired purpose obligations.

(5) *Materially higher.* (i) The yield produced by acquired obligations is materially higher than the yield produced by an issue of governmental obligations if the yield produced by the acquired obligations exceeds the yield produced by the issue of governmental obligations by more than (A) one-eighth of 1 percentage point or (B), at the election of the issuer, one-half of 1 percentage point if the issuer waives the provisions of paragraph (b) (1) through (5) of § 1.103-14 (relating to the temporary period). Notwithstanding an election under (B) of this subdivision, the requirements of paragraph (b)(2)(ii) of § 1.103-14 (relating to the expenditure test) must be satisfied. See paragraph (b)(5) (ii) and (iii) of this section for rules regarding refunding proceeds, and see paragraph (b)(5)(iv) of this section for rules regarding an over-issuance of obligations.

(ii) In the case of a refunding issue, the rules of paragraph (b)(5)(iii) of this section apply to such issue in lieu of the provisions of paragraph (b)(5)(i) and (e)(1)(ii) of this section. The term "refunding issue" is defined in § 1.103-14(e)(2)(i).

(iii) (A) Prior to the date on which the last obligation of the prior issue (as defined in § 1.103-14(e)(2)(i)) is discharged, the yield produced by acquired obligations allocated to the proceeds (other than transferred proceeds as defined in § 1.103-14(e)(2)(ii)) of the refunding issue is materially higher than the yield produced by such issue if the yield on such acquired obligations is higher than—

$$Y+[(\$25{,}000\times Y)\div P]$$

where—

(*1*) "Y" stands for the yield on the issue, and

(*2*) "P" stands for the amount of the original proceeds of the issue.

(B) The rules of paragraph (b)(5)(i) of this section apply to the yield produced by acquired obligations allocated to (*1*) transferred proceeds and (*2*) on or after the date on which the last obligation of the prior issue is dis-

charged, other proceeds of the refunding issue. The determination as to whether the yield on acquired obligations allocated to transferred proceeds is materially higher shall be made with reference to the yield on the refunding issue. The rules of paragraph (b)(5) (i)(B) and (iv) of this section and the rules of paragraph (e)(1)(ii) of this section shall apply to transferred proceeds if such rules applied to the prior issue.

(C) If a refunding issue refunds a prior issue that is a refunding issue, proceeds of the prior refunding issue that would be treated as transferred proceeds of the subsequent refunding issue under § 1.103-14(e)(2)(ii) shall not be treated as transferred proceeds prior to the date on which the last obligation of the issue which is not a refunding issue is discharged by the prior refunding issue or series of refunding issues. Rather, prior to that date, such proceeds shall be treated as proceeds of the subsequent refunding issue in applying this subdivision (iii). After such date, paragraph (b)(5)(iii)(B) applies to such proceeds.

(iv) If it is reasonably expected that the original proceeds of an issue will exceed the amount necessary for the governmental purpose or purposes of the issue by more than 5 percent of such amount, the rules of this subdivision shall apply in lieu of the provisions of paragraph (b)(5) (i) and (iii) of this section. Any portion of the issue issued solely for the purpose of investing such portion at a materially higher yield as less than a major portion is not issued for a governmental purpose. If there are two or more projects (within the meaning of § 1.103-14(b)(2)), such projects shall, for purposes of this subdivision, be deemed to be a single governmental purpose. The yield produced by acquired obligations acquired with the proceeds of such issue (including any acquired obligations held during the temporary periods described in § 1.103-14(b), any amounts invested in the reserve or replacement fund as defined in § 1.103-14(d), and any investments of less than a major portion of such proceeds as described in paragraph (b)(1) of this section) is materially higher than the yield produced by an issue of governmental obligations if the yield produced by the acquired obligations is higher than—

$$Y+[(\$5{,}000\times Y)\div P]$$

where—

(A) "Y" stands for the yield on the issue, and

(B) "P" stands for the amount of the original proceeds of the issue.

Nothing in this subdivision implies that a deliberate over-issuance of less than 5 percent will not be treated as an artifice or device (§ 1.103-13(j)).

(v) The following examples illustrate the application of paragraph (b)(5)(iv) of this section:

Example (1). On July 1, 1987, city A sells $10 million of 7-percent series A revenue bonds and $5 million of 4-percent series B special obligation bonds at par in the full cash defeasance of a prior issue. Assuming that under State law and the bond indenture the amount necessary to achieve the purpose of the refunding is only $10 million, paragraph (b)(5)(iv) of this section applies to both the series A and the series B issues.

Example (2). On July 1, 1988, city B sells $10 million of 7-percent revenue bonds at par. One and a half million dollars of the bond proceeds will be placed in a debt service reserve fund and invested for 25 years in Treasury bonds at a yield of 8½ percent. Assume that a reserve fund of no more than $800,000 is reasonably required for the revenue bonds. Based on these facts, paragraph (b)(5)(iv) of this section applies to the revenue bonds. Therefore, the revenue bonds are arbitrage bonds.

Example (3). On July 1, 1989, city C has outstanding $20 million of revenue bonds. In addition, city C has accumulated $15 million in a sinking fund for the revenue bonds. Assume that city C sells approximately $23 million of refunding bonds at par, defeasing the prior issue and freeing the sinking fund from any lien. The $15 million held in the sinking fund will continue to be invested in long-term Treasury bonds. Of the proceeds of the refunding issue, $20 million will be used to call the revenue bonds at par and $3 million will be used to establish a reserve of $3 million. Based on these facts, paragraph (b)(5)(iv) of this section applies to the refunding issue. The amount necessary to call the outstanding revenue bonds is only $5 million (i.e., $20 million less the $15 million held in the sinking fund). Thus, at least $15 million of the proceeds of the refunding issue will not be needed for any governmental purpose.

(vi) Except as provided in subdivision (viii) of this subparagraph (and despite anything in § 1.103-13 (b) or (e) to the contrary), § 1.103-13(b)(5)(vii) applies to any acquired obligation that is allocated to amounts treated as proceeds under § 1.103-13(g) (relating to invested sinking funds).

(vii) Materially higher than the yield on an issue means higher than—

$$Y+[(\$5{,}000\times Y)\div F]$$

where—

(A) "Y" stands for the yield on the issue, and

(B) "F" stands for the maximum amount that will be accumulated in a sinking fund (or funds) for the issue.

(viii) The yield on an acquired program obligation is materially higher than the yield on an issue if the yield on the acquired program obligation exceeds—

(A) The yield on the issue, plus

(B) One and a half percentage points.

(ix) In lieu of the amount described in § 1.103-13(b)(5)(viii)(B), the issuer may substitute such larger amount as is necessary to pay expenses (including losses resulting from bad debts) reasonably expected to be incurred as a direct result of administering the program to the extent that such amounts are not payable with funds appropriated from other sources.

(6) *Date of issue.* The date of issue of an obligation is the date on which there is a physical delivery of the evidences of indebtedness in exchange for the amount of the issue price. For example, obligations are issued when the issuer physically exchanges the obligations for the underwriter's (or other purchaser's) check.

(7) *Term of an issue.* The term of an issue is the period beginning on the date of issue and ending on the latest maturity date of any obligation of the issue without regard to optional redemption dates.

(8) *Bond indentures and related documents.* The term "bond indenture" includes a bond resolution or ordinance. With respect to a bond indenture, the term "related documents" includes, for example, a trust agreement, a prospectus, or a transcript of proceedings and accompanying certificates.

(9) *Multipurpose issues.* (i) In the case of an issue of governmental obligations—

(A) Issued to finance two or more projects with respect to which the temporary periods provided in paragraph (b) (1) or (5) of § 1.103-14 are different (including different temporary periods resulting from an election under paragraph (b)(5)(i)(B) of this section), or

(B) Part of the proceeds of which are used for refunding to which the rules of paragraph (e) of § 1.103-14 apply or for a governmental program to which the rules of paragraph (h) of this section apply,

the portion of the proceeds of such governmental obligations to be used to finance project having different temporary periods or to be used partly for refunding or partly for a governmental program shall be treated as separate issues of governmental obligations for purposes of determining the temporary period requirements, the reasonably required reserve or replacement fund, the application of the major portion test, and the application of § 1.103-15 (relating to excess proceeds) with respect to each such separate issue.

(ii) For purposes of this section and for purposes of § 1.103-14, the term "project" means any governmental purpose financed by the issue of governmental obligations. Such purpose does not include the investment of the proceeds of such issue in acquired nonpurpose obligations.

(10) *Issue.* (i) Two or more obligations are part of the same "issue" if the obligations—

(A) Are issued at substantially the same time,

(B) Are sold pursuant to a common plan of financing, and

(C) Will be paid out of substantially the same source of funds (or will have substantially the same claim to be paid out of substantially the same source of funds).

All other facts such as whether the obligations are offered by the same official statement or are sold under the

same indenture) are irrelevant for purposes of this subparagraph.

(ii) The following examples illustrate the application of this subparagraph:

Example (1). On January 1, 1980, city T issues $10,000,000 of series A revenue bonds and on January 7, 1980, city T issues $5,000,000 of series B revenue bonds. The series A and series B bonds are sold pursuant to a common plan of financing and both will be paid solely out of revenues of the city T water works. Based on these facts, the series A and series B bonds are all part of one issue.

Example (2). The facts are the same as in example (1), except that the series B bonds are special obligation bonds and will be paid out of interest on Treasury obligations. Because the series A and series B bonds will not be paid from the same source of funds, they are treated as separate issues.

(11) *Discharged.* An issue is "discharged" when cash is available on the date due (whether at maturity or upon prior call for redemption) at the place of payment and interest ceases to accrue on the issue.

(12) *Bona fide debt service fund.* (i) A bona fide debt service fund is a fund that is used primarily to achieve a proper matching of revenues and debt service within each bond year.

(ii) A bona fide debt service fund for a single issue must be depleted at least once a year except for a reasonable carryover amount (not to exceed the greater of (A) 1 year's earnings on the fund or (B) one-twelfth of annual debt service).

(iii) A bona fide debt service fund may be established for two or more issues, provided that the total amount in the fund at no time exceeds the total of the amounts that could be held in bona fide debt service funds established separately for each of the issues.

(c) *Computation of yield*—(1) *In general.* (i) Paragraph (c)(1)(iii) of this section provides rules to determine the yield on acquired nonpurpose obligations allocable to a refunding issue. Paragraph (c)(1)(ii) of this section provides rules to determine yield on governmental obligations and all other acquired obligations.

(ii) For purposes of this section and § 1.103-14, the term "yield" means that yield which when used in computing the present worth of all payments of principal and interest to be paid on the obligation produces an amount equal to the purchase price. The yield on both governmental obligations and acquired obligations shall be calculated by the use of the same frequency interval of compounding interest. Thus, for example, if the yield on the governmental obligations is determined on the basis of semiannual interest compounding, then the yield on acquired obligations acquired with the proceeds of such governmental obligations shall also be expressed in terms of semiannual interest compounding. In the case of governmental obligations, the computation must be made separately for each issue of obligations issued by a governmental unit, except that a single computation may be made for two or more issues if, before the issuance of the last issue, the issuer established to the satisfaction of the Commissioner that the single computation will not distort yield or otherwise tend to defeat the purposes of section 103(c). In the case of acquired obligations, the computation shall be made separately with respect to each class of acquired obligations referred to in paragraph (b)(4)(iv) of this section allocated to an issue of governmental obligations. The yield produced by an acquired obligation which is a security may be computed by any method which is consistent with the principles of the actuarial method of computing yield. For purposes of such computations, securities held beyond the last expected maturity date of the governmental obligations shall be deemed to be sold on such maturity date. In cases where the issuer has no reasonable expectations as to the amount of principal to be repaid on an acquired security at the time that such security is sold, the amount of such principal shall be deemed to be the same as the fair market value of such security on the date of issue of the governmental obligations to which such security is allocated or, if later, the date on which such security is acquired. No yield computation need be made with respect to an acquired obligation while such obligation is held during the temporary period or periods referred to in

paragraph (b) or (e) of § 1.103-14, since yield allocable to such temporary period or periods is disregarded in determining whether a governmental obligation is an arbitrage bond. However, in the case of an acquired obligation which is held during and after a temporary period, if the yield applicable to the temporary period exceeds the yield of a comparable obligation that could be acquired and held only during such temporary period, then the computation of yield on such acquired obligation must be made by taking into account the yield allocable to such temporary period or periods. No computation need be made with respect to acquired obligations which represent a reasonably required reserve or replacement fund under paragraph (d) or (e) of § 1.103-14 or represent investments of less than a major portion of the proceeds within the meaning of paragraph (b)(1) of this section or paragraph (e) of § 1.103-14. See paragraph (b)(5)(iv) of this section for rules regarding an over-issuance of obligations.

(iii) (A) In the case of acquired nonpurpose obligations (as defined in paragraph (b)(4)(iv)(B) of this section) allocable to a refunding issue, the term "yield" means the yield computed under paragraph (c)(1)(ii) of this section based on the market price of the acquired obligations as determined under this paragraph (c)(1)(iii). This paragraph (c)(1)(iii) applies to proceeds of the refunding issue during the period beginning on the date of issue and ending on the date the last obligation of the prior issue is discharged.

(B) The market price of an acquired obligation shall be the mean of the bid and offered prices on an established market where such obligation is traded on the date of issue of the refunding issue, or, if earlier, on the date of a binding contract to acquire such obligation, or if there are no bid and offered prices on such date, on the first day preceding such date for which there are bid and offiered prices. Any acquired obligation for which there is not an established market shall be treated as producing a yield materially higher than the yield of the refunding issue and will cause obligations of the refunding issue to be arbitrage bonds, unless no yield computation is necessary under paragraph (c)(1)(ii) of this section with respect to such acquired obligation. Any market especially established to provide an acquired obligation to an issuer of govermental obligations will not be treated as an established market. For example, if a person sell stripped coupon bonds to issuers of govermental obligations and there is not an established market for sales of such bonds to other persons, such sales will not establish a market. The mean market price may be determined by reference to any appropriate publication, such as, for example, "Composite Closing Quotations for United States Government Securities" published by the Federal Reserve Bank of New York. Where the price of an obligation is quoted on an established market in terms of yield, the market price shall be the price necessary to produce such yield using the method of computing yield under paragraph (c)(1)(ii) of this section (determined without regard to any administrative costs with respect to such obligation). The market price of an acquired obligation may be established by the borrowing practices of the issuer of the obligation, as, for example, by determining the market price based on the interest ordinarily paid by such issuer to persons other than governmental units with respect to obligations of comparable maturities. The market price of a time or demand deposit (other than a deposit acquired with transferred proceeds) shall be determined under the preceding sentence by taking into account the yield that would be paid by the obligor if the deposit were held as an interest bearing deposit for the expected period of the deposit, except that if the yield actually paid is higher than such yield the market price shall be the amount of the deposit. If the price paid for an obligation is lower than the mean market price, such lower price shall be the market price for purposes of this paragraph. If the price paid for an obligation is higher than the mean market price, such higher price may be used as the market price only if the obligation is acquired in an arm's length transac-

tion without regard to any amount paid to reduce the yield on the obligation. For purposes of this paragraph, where a United States Treasury obligation is acquired directly from the United States Treasury, such acquisition shall be treated as establishing a market for such obligation and as establishing the market price of such obligation.

(C) The market price of a certificate of deposit issued by a commercial bank may be determined as the bona fide bid price quoted by a dealer who maintains an active secondary market in such certificates of deposit.

(iv) The rules in paragraph (c)(1)(iii) shall also apply to acquired obligations that are allocable to amounts treated as proceeds under paragraph (g) of this section.

(2) *Classes of acquired obligations.* The yield produced by a class of acquired obligations shall be computed as if all of the obligations of such class comprised a single issue of obligations, whether or not such obligations are to be acquired or held concurrently. Thus, for example, if an issuer uses the proceeds of an issue to acquire two blocks of nonpurpose obligations (such as, for example, Federal obligations) with different interest rates and maturity periods for each block, the yield on such acquired nonpurpose obligations shall be computed as if such issuer acquired one issue of obligations with different interest rates and maturity periods. The maturity period of each acquired obligation shall be the period that the State or local governmental unit will hold such obligation.

(3) *Student loans.* Payments made by the Commissioner of Education pursuant to section 127(a) of the Education Amendments of 1976 are not taken into account in determining yield on student loan notes.

(4) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. (i) On January 1, 1984, city A sells for a premium of $100,000 a 5-year $1 million obligation. City A will make semiannual interest payments beginning on July 1, 1984, of $36,425.88 and will make the $1 million principal payment on January 1, 1989. The proceeds of the issue are to be used for a municipal construction project, and city A reasonably expects on the date of issue that the project will be paid for by January 1, 1987. A portion of the proceeds of the issue are invested in a reasonably required reserve or replacement fund which will extend through the term of the issue. On January 1, 1984, $9,800 of the proceeds of the issue (other than the proceeds invested in the reasonably required reserve and replacement fund) are used to buy an acquired obligation which has a par value of $10,000 a stated interest rate of 4.7585 percent per annum, and a maturity date of January 1, 1989. Interest on the acquired obligation will be paid annually at the rate of $475.85. Interest on the acquired obligation will be used when received to pay construction expenses as received.

(ii) The yield on the governmental obligations is 5 percent and is computed as follows:

Date	Payments (interest and principal)	Present worth factor	Column (1) times column (2)
7-1-84	$36,425.88	$0.97560976	$35,537.44
1-1-85	36,425.88	0.95181440	34,670.68
7-1-85	36,425.88	0.92859941	33,825.05
1-1-86	36,425.88	0.90595064	33,000.05
7-1-86	36,425.88	0.88385429	32,195.17
1-1-87	36,425.88	0.86229687	31,409.92
7-1-87	36,425.88	0.84126524	30,643.83
1-1-88	36,425.88	0.82074657	29,896.42
7-1-88	36,424.88	0.80072836	29,167.24
1-1-89	36,425.88	0.78119840	28,455.84
1-1-89	1,000,000.00	0.78119840	781,198.40
Total			1,100,000.04

The present worth factor represents the present worth of a dollar payable at the specified future date based on an annual rate of 5 percent compounded semiannually.

(iii) The yield on the acquired obligation is 5.124257 percent and is computed as follows:

	Payments (interest and principal)	Present worth factor	Column (1) times column (2)
Year 1	$475.85	$0.9506615900	$452.37
Year 2	475.85	0.9037574700	430.05
	10,000.00	0.9037574700	9,037.57
Total			9,919.99

The present worth factor represents the present worth of a dollar payable at the specified future date based on an annual interest rate of 5.124257 percent compounded semiannually. Since the yield on the acquired obligation allocable to the temporary period does not exceed the current market true yield on a comparable acquired obligation held for a 3-year period, no yield computation need be made with respect to such acquired obligation while it is held during the 3-year temporary period. Thus, the yield is computed as though the obligation matured on January 1, 1986, and as though the obligation were purchased at a discount of $80 (two-fifths of the $200 discount on the obligation).

(5) *Certain administrative costs.* If acquired purpose obligations are allocable (under § 1.103-13(f)) to an issue, then the following rules apply:

(i) In determining the yield on the acquired purpose obligations, administrative costs paid by the obligor shall not be taken into account.

(ii) Subdivision (i) of this subparagraph applies whether or not the obligor's payments are made from bond proceeds and whether or not such payments merely reimburse the issuer. For this purpose, any payments made by the obligor may be treated as reimbursements of administrative costs, *provided* That the present value of such payments does not exceed the present value of administrative costs paid by the issuer.

(iii) In determining the present value of any payments or costs, the yield on the issue (as determined under § 1.103-13 (c) and (d)) shall be used as the discount rate.

(iv) For purposes of this subparagraph, the term "administrative costs" means—

(A) The cost of issuing, carrying, or repaying the issue,

(B) The underwriter's spread, and

(C) The cost of purchasing, carrying, and selling or redeeming acquired purpose obligations.

(6) *Monthly payments.* An issuer may treat regular monthly payments on an acquired purpose obligation as if they were received semiannually.

(7) *Examples.* The following examples illustrate the application of subparagraphs (5) and (6) of this paragraph:

Example (1). On January 1, 1989, authority A sells $1,050,000 of single-family housing bonds. The yield on the bonds is 7 percent (determined under § 1.103-13 (c) and (d) on the basis of semiannual compounding). Authority A uses the bond proceeds to make 50 identical 25-year mortgage loans of $20,000 each. The mortgage loans are acquired program obligations (within the meaning of § 1.103-13(h)). Authority A uses the remaining $50,000 of proceeds to cover the underwriter's spread and to pay other administrative costs on January 1, 1989. Under the terms of each mortgage loan, authority A will receive level monthly payments of $168.98. Of each payment, $161.87 will be denominated principal and interest, and the remaining $7.11 will be denominated a "finance fee." On January 1, 1989, the present value of all these finance fees (using a discount rate of 7 percent) is $50,000. Therefore, these fees merely reimburse authority A for $50,000 of administrative costs. Accordingly, the finance fees are not taken into account in determining the yield on the mortgage notes. Consequently, the yield on the mortgage notes (computed by treating monthly payments as received semiannually on January 1 and July 1 of each year) is only 8.5 percent. Under § 1.103-13(b)(5)(viii), this yield of 8.5 percent is not materially higher than the yield on the single-family housing bonds.

Example (2). The facts are the same as in example (1), except that the entire monthly payment of $168.98 on each mortgage note will be denominated principal and interest. Although the stated interest rate on the mortgage notes is 9.02 percent, the results

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are the same as in example (1). There is no requirement that reimbursement for administrative costs must be stated separately as a finance fee; it may be included in interest.

(8) *Insurance.* (i) Premiums paid to insure a governmental issue are treated as interest paid on the issue, provided that the present value of the premiums is less than the present value of the interest reasonably expected to be saved as a result of the insurance.

(ii) In determining present value for purposes of this subparagraph, the yield on the governmental issue (determined without regard to this subparagraph) shall be used as the discount rate.

(d) *Administrative costs and purchase price*—(1) *Treatment of administrative costs.* Despite anything in paragraph (c) to the contrary, administrative costs shall not be taken into account in determining yield on obligations.

(2) *Purchase price.* (i) If an issue of governmental obligations is sold to the public, the term "purchase price" means the initial offering price to the public (excluding bond houses, brokers, and other intermediaries).

(ii) If an issue of governmental obligations is privately placed, the purchase price of each obligation is the price paid by the first buyer of the obligation. For this purpose, the term "first buyer" does not include any bond house, broker, or other intermediary.

(iii) If the purchase price of an obligation is unreasonably low, then the yield on the obligation shall be determined as if its purchase price were equal to its fair market value on the date of issue.

(3) *Illustrations.* The following examples illustrate the application of this paragraph:

Example (1). On January 1, 1989, city A sells a $10 million issue of 10-year, 6-percent revenue bonds. The purchase price of the issue is $9,800,000. The yield on the revenue bonds is 6.27 percent. Administrative costs are not taken into account in determining yield.

Example (2). On January 1, 1990, city B sells $20 million of 5-percent general obligation bonds to underwriter X for $19,800,000. Underwriter X offers and sells the entire issue to the public at par. The purchase price of the issue is $20 million. The yield on the issue is 5 percent. The underwriter's spread is not taken into account in determining yield.

Example (3). On January 1, 1991, city C sells $12 million of revenue bonds and uses part of the proceeds to buy a 6-percent Treasury note at par. The yield on the Treasury note is 6 percent. Administrative costs are not taken into account in determining yield.

(e) *Exempt abritrage bonds for personnel of educational institutions*—(1) *In general.* Under section 103(c)(3), except as provided in subparagraph (3) of this paragraph, interest paid on an issue of arbitrage bonds is not includible in gross income if—

(i) The bonds are issued as part of an issue 90 percent of the proceeds of which are used to provide permanent financing for real property occupied or to be occupied for residential purposes by the personnel of an educational institution (within the meaning of section 170(b)(1)(A)(ii)) which grants baccalaureate or higher degrees or to replace funds which are so used, and

(ii) The yield on the bonds (computed in accordance with paragraphs (c) and (d) of this section) is not more than 1 percentage point lower than the yield on obligations acquired in providing such financing.

(2) *Other definitions.* The following definitions shall apply for purposes of this paragraph:

(i) The term "real property" means land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). In addition, the term "real property" includes interests in real property. Local law definitions will not be controlling for purposes of determining the meaning of the term "real property" as used in section 103(c)(3) and this paragraph. The term includes items which are structural components of a building such as the wiring, plumbing systems, central heating or central air-conditioning machinery, pipes or ducts, and elevators or escalators installed in the building. The term also includes built-in air conditioners, stoves, refrigerators, and dishwashers, but does not include any

other equipment or accessories which are not structural components of the building.

(ii) The term "personnel of an educational institution" means the personnel who are employed by the institution on a full-time basis for at least one semester even if such persons are also enrolled for a degree and take courses. The determination whether a person is employed on a full-time basis depends upon the customary practice of the educational institution.

(3) *Obligations held by substantial users or related persons.* Subparagraph (1) of this paragraph shall not apply to any bond for any period during which it is held by a person who is a substantial user of the real property financed by the proceeds of the issue of which it is a part or by a member of the family (within the meaning of section 318(a)(1)) of any such person. A person is a substantial user of such real property if he occupies such property for any period in excess of 3 months.

(f) *Allocations of investments and expenditures*—(1) *In general.* A State or local governmental unit shall allocate the cost of its acquired obligations to the unspent proceeds of each issue of governmental obligations issued by such unit. Unspent proceeds of an issue are the proceeds of such issue minus expenditures made with such proceeds other than amounts expended on acquired purpose or nonpurpose obligations. In cases where any such expenditure is made from the proceeds of several issues of governmental obligations or from several types of proceeds, such expenditure shall be allocated among such proceeds. Allocations under this paragraph may be made at any time and under any reasonable method chosen by the State or local governmental unit, provided that the method of allocation satisfies the requirements in subparagraph (4) of this paragraph.

(2) *Repayments of principal.* Repayments of principal on acquired obligations are a reduction in the allocable cost of such acquired obligations. Repayments of principal on acquired purpose obligations are a reduction in the amount of unspent proceeds to which such principal was allocated.

(3) *Time or demand deposits.* The cost of a time or demand deposit may be allocated to the proceeds of an issue of governmental obligations to the extent that such time or demand deposits are maintained for the purposes for which the proceeds of such governmental obligations may be expended (including as a purpose any investments in a reserve or replacement fund). Thus, for example, if authority A, having one issue of governmental obligations outstanding, has a checking account which on January 1, 1984, reflects a balance of $500,000, and if such authority's records show that $200,000 of such balance are proceeds of an outstanding issue of governmental obligations which are to be used to pay construction costs on the project financed with the proceeds of such issue, then authority A may allocate $200,000 of such account to the outstanding issue of governmental obligations.

(4) *Requirements.* (i) All allocations made under this paragraph must be consistent with one another.

(ii) Obligations purchased with the original proceeds of a refunding issue must be allocated to such proceeds.

(iii) Obligations not purchased with original proceeds of a refunding issue may not be allocated to such proceeds.

(iv) Obligations purchased with amounts treated as proceeds under § 1.103-13(g) (relating to invested sinking funds) must be allocated to such amounts.

(v) If any obligation is allocated to two or more sources of funds, each receipt of principal or interest on the obligation must be allocated ratably among the several sources of funds. (See examples (4) and (5) of subparagraph (5) of this paragraph.)

(5) *Examples.* The following examples illustrate the application of this paragraph.

Example (1). On January 1, 1984, authority B issues a $10 million government obligation at a premium of $500,000 for the purpose of purchasing home loans. Authority B expects that prior to September 1, 1984, it will have expenditures and receipts with respect to the issue as follows:

Date	Expenditure	Receipt	Explanation
1-1-84	$50,000		Issuing expenses.
2-1-84	1,000,000		Treasury obligations.
3-1-84	8,000,000		Housing loans.
6-1-84	500,000		Debt service paid with bond proceeds.
8-1-84		$20,000	Interest on Treasury obligation.
8-1-84		50,000	Repayment of principal on Treasury obligation.
9-1-84		200,000	Interest on loans.
9-1-84		10,000	Repayment of principal on housing loans.

When computing the allocable proceeds of the issue as of September 1, 1984, authority B expects to reduce the $10,500,000 original proceeds by the following amounts:

Issuing expenses	$50,000
Debt service	500,000
Repayment of principal on housing loans	10,000
Total	560,000

The following receipts result in an increase in allocable proceeds:

Interest on Treasury obligations	$20,000
Interest on loans	200,000
Total	220,000

Thus, the $10,500,000 original proceeds will be decreased as of September 1, 1984, by a net amount of $340,000, and on such date the amount of allocable proceeds is $10,160,000. The investment in housing loans and Treasury obligations does not decrease unspent proceeds since the investment is for acquired purpose and acquired nonpurpose obligations. The repayment of principal on the Treasury obligations does not increase unspent proceeds. The repayment of principal on the housing loans reduces the amount of unspent proceeds. The repayments of principal on the housing loans and the Treasury obligations reduce the allocable cost of the acquired obligations. Thus, on September 1, 1984, authority B will have $950,000 in Treasury obligations and $7,990,000 in housing loans which may be allocated to the unspent proceeds of the governmental obligations.

Example (2). On January 1, 1984, city C issues a 10-year 5 million dollar revenue bond issue with a yield of 5 percent for the purpose of constructing a revenue producing facility. City C expects to receive, by January 1, 1988, proceeds from the issue as follows:

Proceeds from bond sales	$5,000,000
Investment proceeds	500,000
Total	5,500,000

The city expects expenditures, by January 1, 1988, with regard to the issue as follows:

Issuing expenses	$25,000
Construction expenses	3,750,000
Debt service paid with bond proceeds	250,000
Total qualifying expenditures	4,025,000
Debt service paid with revenues	500,000

On January 1, 1988, city C has $1,475,000 in proceeds which have not been expended on either the project or debt service. (The debt service paid with revenues was not paid with proceeds of the issue and thus does not decrease proceeds.) On January 1, 1988, city C has a reserve or replacement fund for this issue (as described in § 1.103-14(d)) in the amount of $750,000. Also, $50,000 of the investment proceeds are invested for a temporary period (as described in § 1.103-14(b)(6)). As of January 1, 1988, the city may allocate to the proceeds of the issue $675,000 in acquired obligations which do not have a materially higher yield. Furthermore, the city may allocate to the proceeds of the issue $800,000 in acquired obligations with a materially higher yield.

Example (3). On January 1, 1984, city C expects that on January 1, 1988, its records will show the following information regarding the city's outstanding issues of governmental obligations, including the issue of obligations described in example (2):

GOVERNMENTAL OBLIGATIONS

Date of issue	Yield	Proceeds which may be used to acquire materially higher yield acquired obligations	Proceeds which may be used to acquire obligations which do not have a materially higher yield
3-5-65	4.3		
12-13-79	7.7		

GOVERNMENTAL OBLIGATIONS—Continued

Date of issue	Yield	Proceeds which may be used to acquire materially higher yield acquired obligations	Proceeds which may be used to acquire obligations which do not have a materially higher yield
5-6-80	6.1	$475,000	$525,000
6-10-81	5.3	950,000	1,200,000
1-1-84	5.0	800,000	675,000
Total		2,225,000	2,400,000

Assume that the issue of December 13, 1979, is an issue of taxable industrial development bonds. City C may allocate its acquired obligations using any method it chooses. For January 1, 1988, city C chooses to allocate its acquired obligations as follows:

ACQUIRED OBLIGATIONS

Yield	Cost of acquired obligations	Allocated to issue of May 6, 1980	Allocated to issue of June 10, 1981	Allocated to issue of Jan. 1, 1984
8.0	$2,500,000			
4.0	500,000			$500,000
0	250,000	$250,000		
7.5	1,000,000	275,000		
5.0	1,000,000		$1,000,000	
5.3	500,000		200,000	175,000
7.0	125,000			
Total	5,875,000	525,000	1,200,000	675,000

City C also allocates $2,225,000 of acquired obligations to the $2,225,000 in proceeds of issues which may be used to acquire materially higher yield acquired obligations. The $250,000 acquired obligation allocated to the May 6, 1980, issue is a noninterest bearing cash deposit which the city maintains as a replacement fund for the project which was constructed with the proceeds of that issue. It is unnecessary to make any further allocations because the obligations issued on March 5, 1965, are not subject to the provisions of section 103(c), since they were not issued after October 9, 1969, and the obligations issued December 13, 1979, are taxable industrial development bonds.

Example (4). On February 1, 1980, county T issues series A revenue bonds and series B special obligation bonds in the full cash defeasance of a prior issue. $40,000 of proceeds of the series A issue and $60,000 of proceeds of the series B issue are used together to purchase an acquired obligation. County T allocates interest with a present value of $60,000 to the series B issue and the remaining interest and principal to the Series A issue. This allocation is improper. Instead, county T must allocate 40 percent of each payment of principal or interest on the acquired obligation to the series A issue and 60 percent of each such payment to the series B issue; no other allocation is permitted.

Example (5). On February 1, 1980, city A issues $10 million of revenue bonds for the purpose of constructing a water treatment facility. On the same day, city A purchases an acquired obligation for $1 million. Two hundred thousand dollars of the acquired obligation is allocated to proceeds of the revenue bonds that are held in a reserve fund and invested at an unrestricted yield (see § 1.103-14(d)), $700,000 of the acquired obligation is allocated to proceeds of the revenue bonds that are invested at a restricted yield, and the remaining $100,000 is allocated to other funds (which are not proceeds of the revenue bonds). Of each payment of principal and interest on the acquired obligation, city A must allocate 20 percent to the bond proceeds that are invested at an unrestricted yield, 70 percent to the bond proceeds that are invested at a restricted yield, and 10 percent to the other funds.

(g) *Invested sinking funds*—(1) *In general.* Amounts held in a sinking fund for an issue (and receipts from investment of the sinking fund) are treated as proceeds of the issue.

(2) *Sinking fund.* The term "sinking fund" includes a debt service fund, redemption fund, reserve fund, replacement fund, or any similar fund, to the extent that the issuer reasonably expects to use the fund to pay principal or interest on the issue.

(3) *Withdrawals.* Amounts withdrawn from a sinking fund are not treated as proceeds under this paragraph after they are withdrawn.

(4) *Prior issue.* Original proceeds, investment proceeds, and transferred proceeds of a prior issue are not treated as proceeds of a refunding issue under this paragraph. See, however, § 1.103-14(e)(2)(ii) for rules relating to transferred proceeds.

(5) *Other proceeds.* Amounts treated as proceeds of an issue under § 1.103-13(b)(2) (relating to original proceeds and investment proceeds) are not treated as proceeds of the issue under this paragraph.

(6) *Allocation.* A sinking fund for two or more issues must be allocated between the issues either—

(i) In proportion to their original face amounts, or

(ii) According to the total amount of debt service on the issues that will actually be paid from the sinking fund.

(7) *Illustrations.* The following examples illustrate the application of this paragraph:

Example (1). On January 1, 1989, city A sells $8 million of general obligation bonds at par. All the proceeds of the general obligation bonds will be spent before January 1, 1990, to build a new library. Beginning on January 1, 1990, city A will make periodic deposits into a sinking fund for the general obligation bonds. The amount held in the sinking fund will increase until it equals $6 million on January 1, 2018, and then it will be used to retire all of the outstanding general obligation bonds. The first $1.2 million (i.e., .15 × $8 million) accumulated in the sinking fund may be invested at an unrestricted yield pursuant to § 1.103-13(b)(1)(ii) (relating to the major portion test). Except as provided in § 1.103-14(d) (relating to temporary periods), none of the remainder may be invested at a yield that is materially higher (within the meaning of § 1.103-13(b)(5)(vii)) than the yield on the general obligation bonds.

Example (2). The facts are the same as in example (1). In addition, city A establishes a bona fide debt service fund for the general obligation bonds. No amounts are held in the debt service fund longer than 13 months. The result is the same as in example (1).

(h) *Acquired program obligations*—(1) *General rule.* The term "acquired program obligations" means acquired purpose obligations that carry out the purpose of a governmental program described in subparagraph (2) of this paragraph.

(2) *Governmental programs.* A governmental program is described in this subparagraph if—

(i) The program involves the acquisition of acquired purpose obligations;

(ii) At least 90 percent of all such obligations acquired under the program, by amount of cost outstanding, are evidences of loans to a substantial number of persons representing the general public, loans to exempt persons within the meaning of section 103(b)(3), loans to provide housing and related facilities, or any combination of the foregoing;

(iii) At least 90 percent of all of the amounts received by the governmental unit with respect to obligations acquired under the program shall be used for one or more of the following purposes: To pay the principal or interest or otherwise to service the debt on governmental obligations relating to the governmental program; to reimburse the governmental unit, or to pay, for administrative costs of issuing such governmental obligations; to reimburse the governmental unit, or to pay, for administrative and other costs and anticipated future losses directly related to the program financed by such governmental obligations; to make additional loans for the same general purposes specified in such program; or to redeem and retire governmental obligations at the next earliest possible date of redemption; and

(iv) The program documents require that any person (or any related person, as defined in section 103(b)(6)(C)) from whom the governmental unit may, under the program, acquire obligations shall not, pursuant to an arrangement, formal or informal, purchase the governmental obligations in an amount related to the amount of the obligations to be acquired under the program from such person by the governmental unit.

(3) *Examples.* The following examples illustrate governmental programs described in subparagraph (2) of this paragraph:

Example (1). State A issues obligations the proceeds of which are to be used to purchase certain home mortgage notes from commercial banks. The purpose of the governmental program is to encourage the construction of low income residential housing by creating a secondary market for mortgage notes and thereby increasing the availability of mortgage money for low income housing. Amounts received as interest and principal payments on the mortgage notes are to be used for one or more of the following purposes: (1) To service the debt on the governmental obligations, (2) to retire such obligations at their earliest possible date of redemption, and (3) to purchase additional mortgage notes. The governmental program is one which is described in subparagraph (2) of this paragraph.

Example (2). State B issues obligations the proceeds of which are to be used to make loans directly to students and to purchase from commercial banks promissory notes made by students as the result of loans made to them by such banks. The legislation authorizing the student loan program provides that the purpose of the program is to enable financially disadvantaged students to continue their studies. The legislation also provides that purchases will be made from banks only where such banks agree that an amount at least equal to the purchase price will be devoted to new or additional student loans. The governmental program is one which is described in subparagraph (2) of this paragraph.

Example (3). Authority C issues obligations the proceeds of which are to be used to purchase land to be sold to veterans. The governmental unit will receive purchase-money mortgage notes secured by mortgages on the land from the veterans in return for such land. The purpose of the program is to enable veterans to acquire land at reduced cost. Amounts received as interest and principal payments on the mortgage notes are to be used for one or more of the following purposes: (1) To pay the administrative costs directly related to the program, (2) to service the debt on the governmental obligations, (3) to retire such governmental obligations at their earliest possible call date, and (4) to purchase additional land to be sold to veterans. The governmental program is one which is described in subparagraph (2) of this paragraph.

(i) [Reserved.]

(j) *Artifice or device.* If an artifice or device is employed in connection with the issuance of a governmental obligation, such obligation will be considered an arbitrage bond within the meaning of section 103(c)(2). For purposes of this section, the term "artifice or device" means a transaction or series of transactions that attempts to circumvent the provisions of section 103 (c), this section, § 1.103-14, or § 1.103-15—

(1) Enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to gain a material financial advantage, and

(2) Increasing the burden on the market for tax-exempt obligations.

Examples of increased burdens on the market for tax-exempt obligations include selling obligations that would not otherwise be sold, selling more obligations than would otherwise be necessary, and issuing obligations sooner or allowing them to remain outstanding longer than would otherwise be necessary. In no case shall it be considered an artifice or device to invest bond proceeds (or amounts treated as bond proceeds) at a materially higher yield if specifically provided for in section 103(c)(4). The provisions of this paragraph may be illustrated by the following examples:

Example (1). Authority E decides to refund certain revenue bonds. However, E intentionally delays the issuance of the refunding bonds until 2 years before the call date of the refunded bonds in order to take advantage of the 2-year temporary period provided by § 1.103-14(e)(3)(ii)(B). The ability of authority E to invest proceeds of the refunding issue at a materially higher yield during the temporary period makes this refunding more attractive than would be the case if such investment were not permitted. Authority E's decision to delay the issuance of the refunding bonds to take advantage of this temporary period is not an artifice or device within the meaning of this paragraph because investment of bond proceeds at a materially higher yield during a temporary period is specifically provided for in section 103(c)(4). In addition, the purpose of the temporary period in § 1.103-14(e)(3)(ii)(B) is to encourage issuers to delay advance refundings until later in the term of the prior issue.

Example (2). On January 1, 1981, authority K sells $1 million of 40-year industrial development bonds at par. The proceeds of the industrial development bonds will be needed to make a $1 million loan to corporation X for 5 years. When the principal of

the loan is repaid on January 1, 1986, authority K will invest this sum in Treasury bonds at a yield that is materially higher than the yield on the industrial development bonds. By selling bonds with a term that is 35 years longer than necessary, authority K has attempted to use an artifice or device to defeat the purpose of section 103(c).

Example (3). On January 1, 1981, city L sells $10 million of tax anticipation notes. For purposes of determining the cumulative cash flow deficit on January 1, 1982, city L assumes that the amount of its anticipated expenditures for the month of January 1982 is reasonably required as a cash balance. See § 1.103-14(c)(2). City L conducts no investigation into its actual cash balance requirements. Therefore, city L is unable to ascertain whether 1 month's expenditures is, in fact, a reasonable balance. City L has not used an artifice or device in connection with the tax anticipation notes. The purpose of the 1-month figure in § 1.103-14(c)(2)(ii) is to eliminate the need for city L to conduct an investigation of its cash balance requirements.

Example (4). On January 1, 1983, city M sells $10 million of 6-percent refunding bonds. The proceeds of the refunding bonds will be held in escrow until they are used to pay principal and interest on a 3-percent prior issue. Although the prior issue is callable at par, it will be left outstanding until maturity. Moreover, amounts held in the escrow will be invested at a yield of 6 percent. Based on these facts, city M has not used an artifice or device. It has allowed the 3-percent prior issue to remain outstanding merely because it would be unwise to buy back the prior issue at par. Further, city M does not stand to make any profit by exploiting the difference between taxable and tax-exempt interest rates.

[T.D. 7627, 44 FR 32658, June 7, 1979]

§ 1.103-14 Temporary investments, reserve funds, and refunding issues.

(a) *Temporary investments*—(1) *In general.* Under section 103(c)(4)(A), an obligation shall not be treated as an arbitrage bond solely by reason of the fact that all or a portion of the proceeds of the issue of which such obligation is a part may be invested in materially higher yield acquired obligations for a temporary period until such time as such proceeds are used for the purpose for which such obligations were issued. Thus, the investment for such temporary period of the proceeds of an issue of governmental obligations in acquired obligations which produce a yield materially higher than the yield produced by such issue of governmental obligations will not cause such governmental obligations to be treated as arbitrage bonds. See paragraph (d) of this section for rules with respect to a reasonably required reserve, and see § 1.103-13(b)(1) for rules relating to the major portion test.

(2) *Multipurpose issues.* See § 1.103-13(b)(9) for rules regarding application of the temporary period requirements to an issue which finances two or more projects with different temporary periods.

(b) *Temporary period.*—(1) *In general.* Original proceeds and investment proceeds of an issue of governmental obligations that are invested in acquired obligations during a 3-year period (or the period determined under paragraph (b)(5) of this section) beginning on the date of issue are invested for a temporary period if the requirements of paragraph (b) (2), (3), and (4) of this section are satisfied. See paragraph (b)(6) for the temporary period relating to investment proceeds. This paragraph (b) does not apply in the case of an issue of obligations issued in anticipation of taxes or other revenues. See paragraph (c) of this section for rules relating to temporary periods for tax and other revenue anticipation notes.

(2) *Expenditure test.*—(i) An amount equal to 85 percent of spendable proceeds must be expended on the project or projects by the end of the period described in paragraph (b)(1) of this section which applies to the issue.

(ii) In the case of an election under § 1.103-13(b)(5)(i)(B) (relating to materially higher), 85 percent of spendable proceeds must be expended on the project or projects by the end of the 3-year period beginning on the date of issue and an amount equal to 95 percent of spendable proceeds must be expended on the project or projects by the end of the 4-year period beginning on the date of issue.

(iii) The term "spendable proceeds" means, in respect of an issue of governmental obligations, the original proceeds described in paragraph (b)(2)(i) of § 1.103-13 minus the sum of (A) the amount of any reasonably required reserve or replacement fund for

the issue (within the meaning of paragraph (d) of this section), (B) the excess of the amount of any original proceeds which, if invested, would be treated as less than a major portion of the proceeds (within the meaning of paragraph (b)(1) of § 1.103-13) over the amount determined under paragraph (b)(2)(iii)(A) of this section, and (C) the amount of any original proceeds expended within the temporary period (or the periods described in paragraph (b)(2)(ii) of this section) in payment of the debt service (i.e., principal, interest, or both) on such issue of governmental obligations to the holders of such obligations (as contrasted to a sinking fund payment).

(3) *Time test.* (i) Within 6 months after the date of issue of the governmental obligations, the State or local govenmental unit must incur a substantial binding obligation to commence or acquire the project or projects, whether or not identified on the date of issue, to be financed by the issue. If, however, there are good business reasons, other than arbitrage profit, for the issuer to delay incurring such substantial binding obligation, then the issuer may have a longer period, not to exceed a 1-year period from the date on which such govenmental obligations are issued.

(ii) A substantial binding obligation to commence exists on the date on which the issuer incurs a binding obligation to a third party involving a substantial expenditure for some part of the project, such as, for example, architectural or engineering services, land acquisition, site development, construction materials, or the purchase of equipment for the project, or, in the case of services, commits itself to make an equivalent expenditure for similar services by employees of the issuer.

(iii) A contract or commitment for services which otherwise meets the requirements of this subparagraph shall be considered binding notwithstanding that it is to be performed in several stages, each subsequent stage being conditioned on a new clearance.

(iv) The obligation may be binding by law or by custom and usage. Further, it may be subject to contingencies, provided that the contingencies are not within the issuer's control.

(v) A binding obligation to expend the lesser of (A) an amount equal to 2½ percent of that portion of the estimated total project cost financed by the issue of governmental obligations and by prior issues or (B) $100,000, shall be substantial.

(4) *Due diligence test.* After a substantial binding obligation to acquire or commence the project or projects is incurred (as described in paragrah (b)(3) of this section), work on or acquisition of the project or projects must proceed with due diligence to completion.

(5) *Exception.* (i) If investments of proceeds do not qualify as investments for a temporary period because the requirement of paragraph (b)(2)(i) of this section (relating to the expenditure test) is not satisfied, such investments shall nevertheless be considered to be for a temporary period if prior to the issuance of the governmental obligations the issuer demonstrates to the satisfaction of the Commissioner that, on the basis of facts, estimates, and circumstances in existence on the date of such issue, a longer temporary period is necessary.

(ii) In the case of an issue of governmental obligations issued to finance a construction project, if investments of proceeds do not qualify as investments for a temporary period because the requirement of paragraph (b)(2)(i) of this section (relating to the expenditure test) is not satisfied, such investments shall nevertheless be considered to be for a temporary period if the issuer certifies under § 1.103-13(a)(2)(ii) that on the basis of the facts, estimates, and circumstances in existence on the date of issue, a longer temporary period not exceeding a 5-year period beginning on the date of issue is necessary.

(6) *Investment proceeds.* Investment proceeds of an issue of governmental obligations that are invested during the period described in paragraph (b)(1) of this section during a 1-year period beginning on the date of the receipt of such investment proceeds are invested for a temporary period.

(7) *Replacement issue.* (i) In the case of a replacement issue of obligations

(as defined in paragraph (b)(7)(ii) of this section) that replaces an earlier issue of obligations of the issuer, the period described in paragraph (b)(1) of this section for the replacement issue shall be reduced by a period equal to the period during which the obligations of the earlier issue were outstanding. See paragraph (e)(3) of this section for rules relating to temporary period for a refunding issue.

(ii) The term "replacement issue of obligations" means any obligations which are issued after the retirement of all or a portion of an earlier issue of obligations if the proceeds of such subsequently issued obligations—

(A) Are used to replace any proceeds of such earlier issue (or of such retired portion) which were not expended on the project for which such earlier issue was issued, and

(B) Are use for substantially the same project as was intended for such replaced and unexpended proceeds.

(8) *Invested sinking funds.* Thirty days is the temporary period for amounts treated as proceeds of an issue because they are accumulated in a sinking fund for the issue (see § 1.103-13(g)). The temporary period begins on the date of accumulation.

(9) *Interest.* Despite subparagraph (8) of this paragraph, one year is the temporary period for amounts received from investment of a sinking fund.

(10) *Debt service fund.* (i) Despite subparagraphs (8) and (9) of this paragraph, 13 months is the temporary period for amounts contributed to a bona fide debt service fund (as defined in § 1.103-13(b)(12)).

(ii) If a portion (but not all) of a fund satisfies the requirement of bona fide debt service fund, then that portion is allowed a 13-month temporary period under this subparagraph. However, the remainder of the fund is not allowed the 13-month temporary period. Thus, for example, assume that a single fund serves both as a bona fide debt service fund and as a reserve fund. The portion of the fund that serves as a bona fide debt service fund is allowed a 13-month temporary period under this subparagraph. However, the remainder of the fund is not allowed a temporary period of 13 months. If this subdivision applies, then the requirement for annual depletion in §1.103-13(b)(12) applies only to the portion of the fund that constitutes a bona fide debt service fund.

(11) *Revolving fund.* (i) The term "revolving fund" means a fund—

(A) That consists of receipts from the sale of property acquired with bond proceeds and payments of principal on acquired program obligations; and

(B) (*1*) That will be used for the acquisition of additional property or acquired program obligations, or

(*2*) Whose governing instrument requires the acquisition of additional property or acquired program obligations to the extent that suitable property or obligations are reasonably available.

(ii) For purposes of this subparagraph, the term "property" does not include securities (within the meaning of section 165(g)(2) (A) or (B)) or obligations (other than obligations described in section 103(a) (1) or (2)).

(iii) Despite subparagraphs (8) to (10) of this paragraph, the temporary period for amounts deposited in a revolving fund is 3 years from the date of deposit.

(12) *Certain new money issues.* (i) In addition to the other temporary periods allowed by this paragraph, a sinking fund for an issue shall have a temporary period that—

(A) Begins on the date of issue, and

(B) Ends on the first call date (but not more than 10 years after the date of issue).

(ii) This subparagraph does not apply to an issue unless the issuer makes a reasonable effort to schedule payment of as much debt service as is practicable in each year before the first call date. Thus, nothing in this subparagraph implies that the use of a sinking fund to postpone the maturity of bonds will not be treated as an artifice or device under § 1.103-13(j). On the other hand, use of the temporary period allowed by this subparagraph is not, in and of itself, an artifice or device.

(iii) This subparagraph does not apply to a refunding issue unless the prior issue had a term of less than 3

years and was issued in anticipation of permanent financing.

(iv) Despite subdivision (iii) of this subparagraph, the term of the prior issue may be longer than 3 years if the issuer demonstrates to the satisfaction of the Commissioner, prior to the issuance of the permanent financing, that a longer period of time was necessary.

(v) If this subparagraph applies to a refunding issue, then the 10-year limit in subdivision (i)(B) shall be reduced by the term of the prior issue.

(vi) The following example illustrates the application of this subparagraph:

Example. On January 1, 1980, housing authority A issues $4 million of bond anticipation notes. The bond anticipation notes have a term of 5 years. On January 1, 1980, authority A reasonably expects to roll the notes over into permanent financing within 3 years. However, due to unexpected difficulties, authority A is unable to issue permanent financing until July 1, 1984. Assume that, prior to July 1, 1984, authority A demonstrates to the satisfaction of the Commissioner that a term of 4½ years was necessary for the temporary financing. Unless subdivision (ii) of this subparagraph applies, amounts accumulated in a sinking fund for the permanent financing will be allowed a temporary period beginning on July 1, 1984, and ending on the first call date. However, this temporary period may in no event exceed 5½ years (i.e., 10 years minus 4½ years).

(13) *Reserve or replacement funds.* (i) In addition to the other temporary periods allowed by this paragraph, where an issuer has applied for a ruling that a reserve or replacement fund is necessary under paragraph (d)(2) or (e)(5)(iii) of this section, any amount in excess of the amount provided in paragraph (d)(1) of this section shall have the temporary period allowed under subdivision (ii) of this subparagraph.

(ii) The excess amount described in subdivision (i) shall have a temporary period that—

(A) Begins on the date of issue, and

(B) Ends 30 days after the earlier of: (*1*) the date the ruling is issued (whether favorable or unfavorable), (*2*) the date the request for such ruling is withdrawn, or (*3*) the date such request is administratively closed by the Internal Revenue Service.

(iii) This subparagraph does not apply unless the ruling request is made at least two weeks prior to the issuance of the governmental obligations, is made in good faith, and satisfies the procedural requirements of § 601.201 (Statement of Procedural Rules).

(14) *Methods of accounting.* For purposes of this paragraph, the issuer may account for a sinking fund in any reasonable manner. Thus, for example, the issuer may use the first-in-first-out method or the last-in-first-out method. Further, if net revenues for any bond year equal or exceed debt service, then the issuer may assume that current debt service is paid entirely from current revenues.

(15) *Illustrations.* The following examples illustrate the application of this paragraph:

Example (1). (a) On September 1, 1980, city W sells a $2 million 20-year issue of 6-percent special assessment bonds. The original proceeds of the issue amount to $1,950,000. Of this amount, $60,000 will be used to make the first payment of interest, $140,000 will be deposited in a reasonably required reserve fund, and the remainder will be used to pave streets.

(b) Persons who own property in city W will be subject to a special assessment totaling $2 million. Each property owner will be required to pay his share of the special assessment in equal annual installments due on August 1 over the next 20 years. The special assessment may be prepaid at any time. However, if the special assessment is not prepaid, then the outstanding balance of the assessment will bear interest at 6 percent, due on August 1 of each year.

(c) $100,000 of the special assessment bonds will mature on September 1 of each year 1981 to 1990. In addition, $1 million of term bonds will mature on September 1, 2000. The term bonds are callable at par beginning on September 1, 1990.

(d) City W will accumulate prepayments of the special assessment in a sinking fund until September 1, 1990. At that time, all amounts in the sinking fund will be used to call term bonds due in the year 2000.

(e) Based on these facts, city W's sinking fund is allowed a 10-year temporary period that ends on September 1, 1990. See subparagraph (12).

(f) After September 1, 1990, the sinking fund will be mandatory in character. All amounts deposited in the sinking fund will be used to call term bonds on September 1 of each year. Therefore, the sinking fund will serve merely as means to match rev-

enues and debt service. Accordingly, amounts deposited in the sinking fund after September 1, 1990, will be allowed a 13-month temporary period under subparagraph (10).

Example (2). On July 1, 1981, authority X sells a $3 million 20-year issue of 6-percent school bonds. Authority X uses the original proceeds of the issue to build a school building and leases the building to school district Y. School district Y has general taxing powers. Under the terms of the lease, school district Y is unconditionally obligated to pay $130,000 on January 1 and July 1 of each year 1982 to 2002. These payments will be sufficient to enable authority X to pay level debt service and retire the school bonds over 20 years. Nevertheless, authority X will not pay any principal on the school bonds until July 1, 1991. Instead, authority X will deposit the excess of rents over interest in a sinking fund until July 1, 1991. Based on these facts, authority X will not make a reasonable effort to pay principal on the school bonds before July 1, 1991. Therefore, rents deposited in the sinking fund will be allowed a temporary period of only 30 days.

(c) *Tax and other revenue anticipation notes*—(1) *In general.* In the case of an issue of obligations issued in anticipation of taxes or other revenues, proceeds that are invested are an investment for a temporary period if such obligations—

(i) Will not be outstanding after (A) a period ending 13 months after the date on which such obligations are issued, (B) a period ending 60 days (but not more than 24 months after such obligations are issued) after the last date for payment without interest or penalty of the anticipated tax (or last installment thereof) imposed by an annual tax levy or the first year's tax (or last installment thereof) of the anticipated tax imposed by a levy for more than 1 year, or (C) in the case of obligations issued in anticipation of governmental grants or advances and not in anticipation of taxes or revenues from other sources, a period ending 6 months after the date on which the issuer expects to receive such grants or advances (but not more than 30 months after such obligations are issued), and

(ii) Will not be issued in an amount greater than the maximum anticipated cumulative cash flow deficit to be financed by such anticipated tax or other revenue sources for the period for which such taxes or other revenues are anticipated and during which such obligations are outstanding.

(2) *Cumulative cash flow deficit.* For purposes of this subparagraph, the cumulative cash flow deficit at any time during a period is an amount equal to:

(i) The amount that the issuing State or local government unit will expend from the beginning of such period to such computation date to pay expenditures which would ordinarily be paid out of or financed by the anticipated tax or other revenues, plus

(ii) The amount reasonably required by the issuer as a cash balance on hand at all times (the amount of the anticipated expenditures for a period of 1 month from such time being deemed to be reasonably required for this purpose), minus

(iii) The sum of the amounts (other than the proceeds of the issue in question), whether in the form of cash, marketable securities, or otherwise which will be available for the payment of such expenditures from the beginning of such period to such time.

(3) *Amount available for payment.* For purposes of paragraph (b)(2)(iii) of this section, amounts in accounts will be considered to be available for the payment of such expenditures to the extent that such accounts may, without legislative or judicial action, be invaded to pay such expenditures without a legislative, judicial, or contractual requirement that such accounts be reimbursed.

(4) *Example.* The following example illustrates the provisions of this paragraph:

Example. County B plans to issue 13-month tax anticipation notes on July 1, 1981, in anticipation of income tax revenues in the amount of $4 million to be received on March 1, 1982, and real property tax revenues in the amount of $8 million to be received on May 1, 1982. Assume that all receipts will be received on the first day of each month. The maximum amount of such notes which may be issued pursuant to the provisions of subparagraph (3) of this paragraph may be determined in accordance with the following table on the basis of the facts assumed:

	Estimated expenditures	Estimated receipts [1]	Cumulative surplus (or deficit) at end of month [2]
June			$2,000,000
July	$750,000	$40,000	1,290,000
August	900,000	36,450	426,450
September	1,100,000	32,132	(641,418)
October	1,250,000	26,782	(1,864,636)
November	1,000,000	20,576	(2,844,060)
December	800,000	15,779	(3,627,281)
January	1,100,000	11,858	(4,716,000)
February	1,280,994	6,417	(6,000,000)
March	1,000,000	4,020,000	(2,980,000)
April	1,535,100	15,100	(4,500,000)
May	975,000	8,475,000	3,000,000
June	1,515,000	15,000	1,500,000

[1] Tax receipts plus proceeds from investments.
[2] Does not include amount of reasonably required cash balance.

The maximum cumulative deficit is $7 million which occurs at the end of February (i.e., $6 million cumulative deficit at the end of February plus $1 million reasonably required as a cash balance on hand (the amount of the anticipated expenditures for March)). Thus, an investment of the proceeds of the county B notes will be an investment for a temporary period if such notes are not issued in an amount in excess of $7 million.

(d) *Reasonably required reserve or replacement fund*—(1) *In general.* Under section 103(c)(4)(B), an obligation shall not be treated as an arbitrage bond solely by reason of the fact that a portion of any proceeds of the issue of which such obligation is a part may be invested in materially higher yield acquired obligations which are part of a reasonably required reserve or replacement fund. Except as provided in subparagraphs (2) and (4) of this paragraph, a reserve or replacement fund will be considered to be reasonably required only if the amount so invested at any time during the term of the issue does not exceed 15 percent of the original face amount of the issue. If the original proceeds of an issue (determined without regard to issuing expenses) are less than 98 percent of the original face amount of such issue, then the percentage specified in the preceding sentence shall be based on the amount of such original proceeds. For the purpose of determining whether the amount invested exceeds the amount specified in the preceding sentence, the rules of § 1.103–13(b)(1)(ii) apply. A reasonably required reserve or replacement fund may consist of one or more funds, or portions of funds, however labeled, derived from one or more sources. Thus, for example, a sinking fund described in § 1.103–13(g)(2) might also be a reasonably required reserve or replacement fund.

(2) *Exception.* If an amount in excess of the amount provided in paragraph (d)(1) of this section is invested in a reserve or replacement fund, such excess will be considered to be invested in a reasonably required reserve or replacement fund if—

(i) The issuer applies for a ruling that the specified reserve or replacement fund is necessary, and

(ii) A ruling to that effect is subsequently issued to the governmental unit (before or after the date of issuance of the obligations).

The procedure set forth in the preceding sentence does not preclude an issuer from relying on a published ruling in which the Commissioner specifically designates a category of reserve or replacement funds as reasonably required.

(3) *Relationship to major portion test.* To the extent that proceeds of an issue of governmental obligations are invested at a materially higher yield in a reasonably required reserve or replacement fund, such proceeds are included as proceeds invested in materially higher yield acquired obligations for purposes of the major portion test in § 1.103–13(b)(1). Thus, if the sum of the proceeds invested in materially higher yield acquired obligations

equals the maximum investment permitted under this paragraph, then the investment of any other proceeds in materially higher yield acquired obligations may cause the obligations of such issue to be arbitrage bonds.

(4) *Pledge of endowment.* Endowment funds of a college, university, or other similar institution (such as a hospital or charity) pledged as collateral for an issue will be considered to be a reasonably required reserve if the pledged funds:

(i) Were derived from gifts or bequests (including the income thereon);

(ii) Were not raised for the purpose of carrying out the project financed by the issue;

(iii) Are not reasonably expected to be used (directly or indirectly) to pay principal or interest on the issue; and

(iv) Are held as part of the institution's permanent capital.

The following example illustrates the application of this subparagraph:

Example. The health and educational facilities authority of State X ("the X authority") plans to issue long-term bonds to finance a new medical school building for college A. The bonds will be collateralized by a pledge of securities held by college A as quasi-endowment funds (funds functioning as endowment). In the financing agreement, college A represents that the pledged securities are quasi-endowment funds derived from gifts or bequests (or the income therefrom) and that it will expend on the construction of the medical school building an amount equal to or greater than the amount of funds raised for the purpose of such construction (including amounts that it reasonably expects to receive in the future from pledges or otherwise), and no such funds will be pledged as collateral for the issue. Authority X is not aware of any facts or circumstances that would cause it to question the accuracy of the representations made by college A. In addition, on the basis of facts and estimates including projections indicating that revenues from other sources during the next 5 years will be more than sufficient to pay debt service on the issue, authority X does not reasonably expect that the pledged funds or the income therefrom will be required to make payment of principal or interest on the issue. Based on the reasonable expectations of authority X, the pledged funds satisfy the requirements of this paragraph. Authority X does not need a ruling under subparagraph (2) of this paragraph.

(5) *Certain mandatory accumulations.* A reserve fund for one or more issues is reasonably required if:

(i) Amounts must be paid into the fund under a constitutional provision, statute, or ordinance adopted before May 3, 1978;

(ii) Under the constitutional provision, statute, or ordinance, amounts paid into the fund (and receipts from investment of the fund) can be used only to pay debt service on the issues and for no other purpose; and

(iii) The size of the payments made into the fund is independent of the size of the outstanding issues (including the debt service thereon).

The following example illustrates the application of this subparagraph:

Example. (i) On June 30, 1979, city B in State A had on deposit in a general bond sinking fund cash and U.S. Government securities aggregating $21 million. The money in the general bond sinking fund was derived principally from a 6½ mill annual city ad valorem tax ("the general bond tax") that is now, and has been for over 50 years, required by the constitution of State A to be used and applied solely for payment of the principal of and the interest on city B's general bonds and that has been levied by city B for more than 50 years. A portion of the money in the general bond sinking fund was derived from the investment of money in the fund. The revenue derived by city B from the general bond tax is received on an annual basis as taxpayers pay their respective annual ad valorem tax. Substantially all such revenue is received by city B during the period from January 1 to January 31 in each year.

(ii) On July 1, 1979, city B created two new funds, a general bond debt service fund (which was created to achieve a proper matching of revenues and debt service within each calendar year) and a general bond reserve fund. Immediately thereafter, city B transferred from the sinking fund—

(1) To the debt service fund the sum of $2 million (an amount equal to the debt service maturing on city B's general bonds during the period July 1, 1979–December 31, 1979), and

(2) To the reserve fund the entire balance ($19 million) then remaining on deposit in the sinking fund.

after which the sinking fund was closed.

(iii) In each of the calendar years ending on December 31, 1980 and 1981, city B received from the general bond tax the sum of $5 million, which it applied (within 30 days after receipt) as follows:

	Year ending Dec. 31	
	1980	1981
To the debt service fund	$3,925,000	$3,840,000
To the reserve fund	1,075,000	1,160,000

(iv) The debt service (principal and interest) maturing with respect to city B's general bonds during each of such 2 years aggregated $4 million, and amounts on deposit in the debt service fund were during each of such years invested in U.S. Government securities. The cash flow of the debt service fund during each of such years, and during 1979, was as follows:

	Year ending Dec. 31		
	1979*	1980	1981
Balance at beginning of period	$2,000,000	$75,000	$160,000
Receipts:			
General bond tax	0	3,925,000	3,840,000
Investment income	75,000	160,000	160,500
	2,075,000	4,160,000	4,160,500
Less expenditures:			
Debt service	2,000,000	4,000,000	4,000,000
Balance at end of period	75,000	160,000	160,500

The entire amount expended from the debt service fund during each of such years was applied and used, on or before the end of each of such years, for payment of debt service on city B's general bonds. The balance remaining on deposit in the debt service fund at the end of each of such years was greater than one-twelfth of the debt service maturing with respect to city B's general bonds during the next succeeding calendar year (but not in excess of the annual earnings on the debt service fund).

(v) Amounts on deposit in the reserve fund during each of the years 1979, 1980, and 1981 were invested in U.S. Government securities. As a result of the transfers and payments into the reserve fund that are referred to in items (ii) and (iii) and the receipt of investment income from the reserve fund, the cash flow of the reserve fund for the years ending December 31, 1979, 1980, and 1981 was as follows:

	Year ending Dec. 31		
	1979*	1980	1981
Balance at beginning of period	$19,000,000	$19,800,000	$22,575,000
Receipts:			
General bond tax	0	1,075,000	1,160,000
Investment income	800,000	1,700,000	1,940,000
Balance at end of period	19,800,000	22,575,000	25,675,000

*For 1979, period was a 6-month one, beginning July 1, 1979.

(vi) City B did not issue any general bonds during the period May 3, 1978, through December 31, 1981. On January 1, 1982, city B issues and sells to underwriters (at par plus accrued interest) $15 million principal amount of general bonds ("the 1982 general bonds") maturing serially in the years 1985–2012. Immediately prior to the issuance of the 1982 general bonds, city B had outstanding $50 million principal amount of other general bonds, being the outstanding portions of issues aggregating $85 million in original principal amount, all of which were sold to underwriters at par plus accrued interest. Thus, immediately following the issuance of the 1982 general bonds, city B will have outstanding $65 million principal amount of general bonds, being the outstanding portions of issues aggregating the $100 million in original principal amount.

(vii) Under the constitution of State A, amounts on deposit in the debt service fund and the reserve fund (and receipts from the investment of those funds) are available for payment of the principal of and the interest on all of city B's general bonds (including the 1982 general bonds and any other general bonds that city B may in the future issue) on a *pari passu* basis and can be used for no other purpose. While city B reasonably expects to use for payment of the principal of and the interest on its general bonds (including the 1982 general bonds) the money paid into the debt service fund out of proceeds to be derived from the levy of the general bond tax, it does not expect to use any of the money in the reserve fund for payment of such debt service except as follows:

(1) In calendar years 1982 to 1988, inclusive, the revenue to be received from the general bond tax are anticipated to be insufficient to pay maturing debt service on city B's outstanding general bonds (including the 1982 general bonds), and it will, it is expected, be necessary for city B to use money in the reserve fund to make up this anticipated deficit in general bond tax receipts;

(2) In other calendar years, it may be necessary to use income from the investment of reserve fund money to provide for payment of maturing debt service on city B's general bonds (including the 1982 general bonds); and

(3) in the case of other deficiencies (presently unanticipated) in current receipts from the general bond tax necessitating an "invasion" of the reserve fund.

City B expects to continue paying the entire proceeds from the general bond bond tax into the debt service fund and the reserve fund as during the years 1979-1981 except for such adjustments as are necessary to reflect (a) increases in debt service on its general bonds resulting from the issuance of the 1982 general bonds and (b) decreases in debt service on its general bonds resulting from retirement of principal of various outstanding series. In the years following the issuance of the 1982 general bonds, the balance on deposit in the reserve fund is expected to show moderate increases (except in the years 1982 to 1988, inclusive), while both the outstanding principal of city B's general bonds and the original principal amount of those thereof that are then outstanding are anticipated to decline. The money on deposit in the debt service fund and the reserve fund are expected continuously to be invested in taxable securities at a yield that will be materially higher than the yield on the 1982 general bonds.

(viii) Except for the debt service fund and the reserve fund, city B has no sinking or other similar fund that it reasonably expects to use for payment of the principal of or the interest on the 1982 general bonds, nor does it expect to create any such fund. While city B has pledged its full faith and credit for payment of the 1982 general bonds, it did not pledge therefor the debt service fund, the reserve fund, or any other specific revenues, funds, or assets of the city, except to the extent that the constitutional provision of State A, referred to in items (i) and (vii) above, may have itself effected or imposed a pledge of the debt service fund and the reserve fund for the benefit of the 1982 general bonds (and for all other general bonds of city B). While city B does not at the time it issues the 1982 general bonds have any present plans for issuing any further general bonds, nothing contained in any of the proceedings of city B relating to the 1982 general bonds imposes any restrictions on the issuance of further general bonds by city B. At the time the 1982 general bonds are issued, city B could, under its then applicable debt limit, issue up to $10 million principal amount of further general bonds without exceeding such debt limit.

(ix) Based upon the foregoing facts, the reserve fund established by city B is reasonably required under paragraph (d)(4) of this section.

(e) *Refunding issue*—(1) *In general.* This paragraph applies to refunding issues. The general rules regarding the temporary period (see paragraph (b) of this section), the reasonably required reserve or replacement fund (see paragraph (d) of this section), and the major portion test (see § 1.103-13(b)(1)) do not apply to a refunding issue except as provided in this paragraph. This paragraph does not apply to proceeds of a prior issue until they become "transferred proceeds" under the rules in subparagraph (2) of this paragraph.

(i) *Operating rules; temporary period.* (A) The rules in this subdivision apply solely for purposes of subparagraph (3) of this paragraph (relating to the temporary period).

(B) If two or more refunding issues are used to refund the same prior issue and if the refunding is in substance a single transaction, then the refunding issues are treated as a single issue.

(C) If a refunding issue is used to refund a portion (but not all) of the prior issue, then the refunded and nonrefunded portions of the prior issue are treated as separate issues.

(D) The following examples illustrate the application of this subdivision:

Example (1). City A has outstanding $10 million of noncallable 9-percent revenue bonds (the "prior issue") due on January 1, 1990. On January 1, 1980, city A issues $6 million of series A 6½-percent general obligation bonds and $4 million of series B 7-percent revenue bonds at par in a crossover refunding of the prior issue. For purposes of the temporary period rules in subparagraph (3), the two refunding issues are treated as a single issue.

Example (2). City B has outstanding $8 million of noncallable 9-percent revenue bonds (the "prior issue") due on January 1, 1990. On January 1, 1980, city A issues $3 million of 6⅝-percent refunding bonds at par in a crossover refunding of a portion of the prior issue. The remaining $5 million of the prior issue will be paid from revenues. Based on these facts, the prior issue is treated as two separate issues—one of $3 million and one of $5 million—for purposes of the temporary period rules in subparagraph (3).

Example (3). City C has outstanding $12 million of noncallable 9-percent revenue bonds (the "prior issue") due according to the following schedule:

[Dollars in millions]	
Jan. 1, 1981	2
Jan. 1, 1982	4
Jan. 1, 1983	6

On January 1, 1980, city C issues $2 million of series B 6½-percent general obligation bonds and $6 million of series A 7-percent guaranteed revenue bonds at par in a crossover refunding of two portions of the prior issue. The proceeds of the series B bonds will be used to pay the $2 million due on January 1, 1981, and the proceeds of the series A bonds will be used to pay the $6 million due on January 1, 1983. The $4 million due on January 1, 1983. The $4 million due on January 1, 1982 will be paid from revenues. For purposes of the temporary period rules in subparagraph (3), the series A and series B issues are treated as a single issue. In addition, the $8 million refunded portion and the $4 million nonrefunded portion of the prior issue are treated as separate issues.

(ii) *Operating rules; transferred proceeds, minor portion, and 4-R fund.* (A) The rules in this subdivision apply solely for purposes of subparagraphs (2), (4), (5), and (6) of this paragraph. Subparagraphs (2), (4), (5), and (6) relate, respectively, to transferred proceeds, the major portion test, the reasonably required reserve or replacement fund, and the adjusted maturity date.

(B) If the proceeds of a refunding issue are used to refund two or more prior issues, then the portion of the proceeds used to refund each prior issue is treated as a separate refunding issue.

(C) If a refunding issue is used to refund a portion (but not all) of a prior issue, then:

(1) The refunded and nonrefunded portions of the prior issue are treated as separate issues,

(2) Unspent proceeds of the prior issue must be allocated ratably between the separate issues, and

(3) If any unspent proceeds of the prior issue are invested at an unrestricted yield pursuant to paragraph (d) of this section or § 1.103-13(b)(1)(ii), those proceeds must be allocated ratably between the separate issues.

(D) Notwithstanding subdivision (ii)(C) of this subparagraph, if a series B issue is used together with one or more series A issues in a gross refunding of a prior issue and if the requirements of § 1.103-15(c)(2) (i), (ii), (iii), and (iv) are satisfied, then:

(1) Each portion of the prior issue that is refunded by one of the series A issues is treated as a separate issue,

(2) All unspent proceeds of the prior issue must be allocated ratably among the separate issues,

(3) If any unspent proceeds of the prior issue are invested at an unrestricted yield pursuant to paragraph (d) of this section or § 1.103-13(b)(1)(ii), those proceeds must be allocated ratably among the separate issues, and

(4) None of the unspent proceeds of the prior issue may be allocated to any portion of the prior issue that is refunded by the series B issue.

For purposes of this subdivision, the terms "series B issue" and "series A issues" have the same meaning as in § 1.103-15(c).

(E) The following examples illustrate the application of this subdivision:

Example (1). City E has outstanding $10 million of noncallable 9-percent revenue bonds and $5 million of noncallable 8-percent revenue bonds due on January 1, 1990. On January 1, 1983, city E issues $15 million of 6-percent general obligation bonds at par in a crossover refunding of both issues of revenue bonds. Under this subdivision, the refunding issue is treated as two separate

issues—one of $10 million and one of $5 million.

Example (2). The facts are the same as in example (1) of subdivision (i) (D) of this subparagraph. Under this subdivision, the prior issue is treated as two separate issues—one $6 million issue ("issue p-1") that is refunded by the series A bonds and one $4 million issue ("issue p-2") that is refunded by the series B bonds. Assuming that $1 million of the proceeds of the prior issue remain unspent on January 1, 1980, $600,000 of these unspent proceeds must be allocated to issue p-1 and the remaining $400,000 must be allocated to issue p-2. Assuming further that $500,000 of the unspent proceeds of the prior issue are invested at an unrestricted yield in a replacement fund, $300,000 of these proceeds must be allocated to issue p-1 and the remaining $200,000 must be allocated to issue p-2.

Example (3). The facts are the same as in example (2) of this subdivision, except that the prior issue will be retired serially. The result is the same except that issues p-1 and p-2 may be further subdivided under subparagraph (6) of this paragraph (relating to adjusted maturity date).

Example (4). The facts are the same as in example (2) of subdivision (i) (D) of this subparagraph. Under this subdivision, the prior issue is treated as two separate issues—one $3 million issue that is refunded and one $5 million issue that is not refunded.

Example (5). The facts are the same as in example (3) of subdivision (i) (D) of this subparagraph. Under this subdivision, the prior issue is treated as three separate issues—one $2 million issue that is refunded by the series A bonds, one $4 million issue that is not refunded, and one $6 million issue that is refunded by the series B bonds.

Example (6). The facts are the same as in example (4) of § 1.103-15(j). As a result of this subdivision, all unspent proceeds of the prior issue would become transferred proceeds of the series A issue, and none would become transferred proceeds of the series B issue. The result would be the same even if some of the proceeds of the series B issue were used to pay principal on the prior issue.

(2) *Definition.* (i) A refunding issue is an issue of governmental obligations the proceeds of which are used to pay any principal or interest on any other issue of governmental obligations (hereinafter referred to as the "prior issue"). The "refunding issue" and "prior issue" must be issued by the same governmental unit or the "prior issue" may be issued by a governmental unit that is included within the governmental unit that issues the refunding issue. The use of proceeds of an issue of governmental obligations within 1 year after the date of issue of such issue to pay interest on other governmental obligations need not be treated as the refunding of a prior issue unless the principal of the other governmental obligations is also refunded. In addition, the use of proceeds of an issue to pay certain capitalized interest (as defined in paragraph (e)(2)(iii) of this section) on a prior governmental issue need not be treated as the refunding of such prior issue. An issue of obligations to which paragraph (c) of this section applies issued in anticipation of revenues to finance annual budget expenses of the issuer (including supplemental appropriations and other expenses) shall not be treated as a refunding issue unless issued to refund a prior issue of obligations of such issuer issued in anticipation of revenues for the same budget period.

(ii) At the time that proceeds of the refunding issue discharge the outstanding principal of the prior issue, proceeds of the prior issue become proceeds of the refunding issue (hereinafter referred to as "transferred proceeds") and cease to be proceeds of the prior issue. In the case of a discharge of a portion of such principal, the amount of proceeds of the prior issue that become transferred proceeds is an amount which bears the same relationship to the total proceeds of such prior issue at the time of such discharge as the amount of such discharged principal bears to the total principal of the prior issue outstanding immediately prior to such discharge. In the case of a refunding issue, as the proceeds of the prior issue become transferred proceeds, those proceeds of the prior issue which are invested in materially higher yield obligations pursuant to the provisions of paragraph (d) of this section or § 1.103-13(b)(1)(ii) shall become transferred proceeds ratably. Generally, it is not necessary to apply the preceding two sentences for purposes of § 1.103-14(e) (4) and (5). (This is because of § 1.103-14(e)(6), which treats different parts of the prior issue as separate issues.)

(iii) For purposes of paragraph (e)(2)(i) of this section, interest on a prior governmental obligation shall be treated as capitalized interest if such interest accrues within the period of time necessary to complete the construction or the acquisition of the project for which such prior issue was issued plus 1 year thereafter. In lieu of the 1 year referred to in the preceding sentence, there may be substituted a period not longer than 5 years if, prior to the issuance of the obligations the proceeds of which are used to pay interest on a prior issue of obligations, the issuer demonstrates to the satisfaction of the Commissioner that because of inadequate revenues during the period of commencement of operations of the project such interest should be treated as capitalized interest. For example, if a first issue is issued on January 1, 1986, to provide funds to construct a hospital and it is necessary to issue a second issue on January 1, 1989, to provide additional funds to complete construction of the hospital, the use of any proceeds of the second issue to pay interest on the first issue during the period needed to complete construction of the hospital, plus one year thereafter, need not be treated as a refunding of the first issue. However, if the hospital had been completed on January 1, 1989, and a second issue is issued on January 1, 1991, both to provide funds for a new wing for the hospital and to pay interest on the 1986 issue, interest on the first issue is not treated as capitalized interest unless the issuer demonstrates that there are not sufficient revenues from the hospital (without regard to any revenues or losses from the new wing) to pay the interest on the first issue accruing during the period beginning January 1, 1989 and ending not later than January 1, 1994.

(iv) Despite § 1.103-14(e)(2)(ii), the term "transferred proceeds" does not include amounts treated as proceeds of the prior issue under § 1.103-13(g) (relating to invested sinking funds).

(3) *Temporary period.* (i) Proceeds (other than transferred proceeds) of a refunding issue that are invested for a period described in paragraph (e)(3)(ii) of this section are invested for a temporary period. Paragraph (e)(3)(ii) (B) and (C) of this section applies only if the period beginning on the date of issue and ending on the date of discharge of the last obligation of the prior issue is not longer than the period determined under such paragraph. Except as provided in the preceding sentence, the issuer shall be allowed the longer of the temporary periods determined under paragraph (e)(3)(ii) (A) or (B) or (at the issuer's option) the temporary period determined under paragraph (c)(3)(ii)(C). This subparagraph (except for subdivision (viii) and (ix)) does not apply to amounts treated as proceeds under § 1.103-13(g) (relating to invested sinking funds). For the temporary period for an invested sinking fund, see § 1.103-14(b) (8) to (12).

(ii) The periods provided by this subdivision are—

(A) A 30-day period beginning on the date of issue;

(B) A period which is not in excess of the shortest of—

(*1*) A period beginning on the date of issue and ending on the date on which the last obligation of the prior issue is discharged,

(*2*) 2 years,

(*3*) A period equal to 25 percent of the term of the refunding issue,

(*4*) A period equal to the greater of—

(*i*) 50 percent of the term of the prior issue, but not more than 6 months, or

(*ii*) 25 percent of the term of the prior issue, or

(*5*) In case of a refunding issue which is part of a series of refunding issues, where a refunding issue is refunded by a refunding issue, 2 years reduced by the sum of all temporary periods for all prior refunding issues in such series to which this subdivision (ii)(B) or paragraph (e)(3)(ii)(C) of this section applied. See paragraph (e)(3)(ii)(C)(*3*) of this section for the application of this subdivision (ii)(B)(*5*) to a refunding issue described in paragraph (e)(3)(ii)(C)(*1*) of this section.

(C)(*1*) In the case of a refunding issue for which different temporary periods under paragraph (e)(3)(ii) (A) or (B) of this section would apply to portions of such issue because

(*i*) Proceeds of the refunding issue are used to pay principal or interest on two or more prior issues, or

(*ii*) One or more portions of the issue is part of a series of refunding issues under paragraph (e)(3)(ii)(B)(*5*) of this section,

(*iii*) The period described in paragraph (e)(3)(ii)(C)(*2*) of this section.

(*2*) The period described in this subdivision (ii)(C)(*2*) is a period determined by (*i*) multiplying the number of months (rounded to at least one decimal point) or days in the period determined under paragraph (e)(3)(ii)(A) or (B) of this section (determined without regard to paragraph (e)(3)(ii)(B)(*1*) of this section and without regard to any allocation under paragraph (e)(3)(ii)(C)(*3*) of this section with respect to such issue) for each such portion of the refunding issue by the amount of principal and interest of the prior issue discharged by each such portion and (*ii*) dividing the sum of the amounts determined under paragraph (e)(3)(ii)(C)(*2*)(*i*) of this section by the total amount of principal and interest to be refund by all portions of the refunding issue.

(*3*) In the case of the refunding of any prior issue to which this subdivision (ii)(C) applied, the reduction referred to in paragraph (e)(3)(ii)(B)(*5*) of this section for the temporary period for such prior issue shall be the temporary period of the issue determined under this subdivision (ii)(C) rather than the periods under paragraph (e)(3)(ii) (A) or (B) of this section used in determining the temporary period of the issue under this subdivision (ii)(C). Because of the application of this subdivision (ii)(C) to a refunding issue, the sum of the temporary period for a portion of such issue and all prior temporary periods under paragraph (e)(3)(ii) (B) or (C) of this section for such portion may exceed 2 years. If such sum exceeds 2 years then, for purposes of determining the amount of the reduction under paragraph (e)(3)(ii)(B)(*5*) of this section for the portions of such issue in which the sum of temporary periods does not exceed 2 years, the temporary period determined under this subdivision (ii)(C) for such other portions shall be increased by a period determined by multiplying such excess by a fraction the numerator of which is the amount of principal and interest to be discharged by the portion exceeding 2 years and the denominator of which is the amount of remaining principal and interest to be discharged by all other portions of such issue. If the temporary period in paragraph (e)(3)(ii)(A) of this section is used for any portion of the issue in determining the temporary period of the issue under this subdivision (ii)(C), and the temporary period under paragraph (e)(3)(ii)(B)(*5*) of this section for such portion is a period shorter than 31 days, then, for purposes of the preceding sentence, the excess shall be the period by which the temporary period under this subdivision (ii)(C) for such issue exceeds 30 days. If, as a result of any increase under this subdivision (ii)(C)(*3*), the cumulative temporary period for another portion exceeds 2 years, such excess shall also be allocated in accordance with this subdivision (ii)(C)(*3*).

(iii) Proceeds to which any temporary period provided in paragraph (b) of this section for the prior issue applied (or to which any temporary period would apply if such prior issue had been issued after October 9, 1969) which become transferred proceeds and are invested during the period beginning on the date of transfer and ending on the date on which the applicable temporary period for such prior issue would end (determined without regard to the discharge of the prior issue) are invested for a temporary period.

(iv) If proceeds of a prior issue are permitted to be invested in materially higher yield acquired obligations beyond any temporary period provided in paragraph (b) of this section because such proceeds were not expended as anticipated (or could be so invested if such prior issue were not discharged), and if prior to the issuance of the refunding issue the issuer demonstrates to the satisfaction of the Commissioner that, on the basis of facts, estimates, and circumstances in existence on the date of issue, a reasonable extension of such investment is necessary for such proceeds, then such proceeds may be invested in ma-

terially higher yield acquired obligations when such proceeds become transferred proceeds. In determining whether an extension under this subdivision is necessary and in determining the period of any such extension, the Commissioner shall take into account (A) whether the proceeds can be expended on the project or projects in a reasonable period of time and (B) the effect of applying such proceeds to pay all or any portion of the principal or interest, when due, of the prior issue.

(v) In the case of a refunding issue, the 1-year period described in paragraph (b)(6) shall not apply to investment proceeds to be used to discharge the prior issue. For the purpose of applying the preceding sentence to investments that are not made with transferred proceeds, a reference to paragraph (e)(3) (i) and (ii) of this section shall be substituted for the reference to paragraph (b)(1) of this section appearing in paragraph (b)(6) of this section.

(vi) Where an issue of obligations to which paragraph (c) of this section applies is a refunding issue, transferred proceeds shall be deemed invested for a temporary period if the obligations of the refunding issue (A) will not be outstanding after the period applicable to the prior issue under paragraph (c)(1)(i) of this section (determined, in the case of the 6 months referred to therein, on the basis of the facts, estimates, and circumstances in existence on the date of issue of the refunding issue) and (B) will not be issued in an amount greater than the amount determined under paragraph (c)(1)(ii) of this section.

(vii) Proceeds of a refunding issue are invested for a temporary period if those proceeds—

(A) Are received as accrued interest for a period not to exceed 6 months and will not be used to discharge the prior issue, and

(B) Are invested and will be expended during the 1-year period beginning on the date of issue.

(viii) Proceeds of a refunding issue that will not be used to discharge the prior issue (other than proceeds described in paragraph (e)(3)(vii) of this section) are invested for a temporary period if those proceeds are invested during a 1-year period beginning on the date of issue but only to the extent that those proceeds either are used to pay issuance costs or do not exceed 1 percent of the original proceeds of the refunding issue.

(ix) Proceeds of a refunding issue that will not be used to discharge the prior issue (other than proceeds described in paragraph (e)(3) (vii) and (viii) of this section) are invested for a temporary period to the extent that those proceeds do not exceed the lesser of—

(A) $10,000, or

(B) One percent of the original proceeds of the refunding issue.

(4) *Major portion test.* (i) Proceeds of a refunding issue may be invested in materially higher yield obligations pursuant to § 1.103-13(b)(1)(ii) (relating to major portion test), subject to the following limitations:

(A) Acquired obligations that are invested at a materially higher yield pursuant to § 1.103-13(b)(1)(ii) may be acquired only with transferred proceeds.

(B) Proceeds of the refunding issue may be invested in materially higher yield acquired obligations pursuant to § 1.103-13(b)(1)(ii) only to the extent that they do not exceed the amount provided in § 1.103-13(b)(1)(ii) determined with reference to the prior issue.

(ii) To the extent that proceeds of an issue of governmental obligations are invested at a materially higher yield in a reasonably required reserve or replacement fund, such proceeds are included as proceeds invested in materially higher yield acquired obligations for purposes of the major portion test in § 1.103-13(b)(1)(ii). See the allocation rule in paragraph (e)(1)(ii) (C) and (D) of this section if less than the outstanding principal amount of the prior issue is refunded with the proceeds of a refunding issue.

(5) *Reasonably required reserve or replacement fund.* (i) Proceeds of a refunding issue (including transferred proceeds) may be invested in materially higher yield acquired obligations pursuant to paragraph (d) of this section (relating to a reasonably required

reserve or replacement fund), subject to the following limitations:

(A) Acquired obligations that are invested at a materially higher yield pursuant to paragraph (d) of this section may be acquired only with transferred proceeds or proceeds of the refunding issue that are not to be used to discharge the prior issue.

(B) At any time before the adjusted maturity date of the prior issue, proceeds of the refunding issue may not be invested at a materially higher yield pursuant to paragraph (d) of this section.

(C) If a refunding issue is a series B issue (within the meaning of § 1.103-15(c)) and if the requirements in § 1.103-15(c)(2) are satisfied, then the proceeds of the refunding issue may not be invested at a materially higher yield pursuant to paragraph (d) of this section.

(ii) See the allocation rule in paragraph (e)(1)(ii) (C) and (D) of this section if less than the outstanding principal amount of the prior issue is refunded with the proceeds of a refunding issue.

(iii) If an amount in excess of the amount allowed under paragraphs (d)(1) and (e)(5) of this section is invested in a reserve or replacement fund for a refunding issue, such excess may be invested at a yield that is materially higher than the yield on the refunding issue only if—

(A) The issuer applies for a ruling that the specified reserve or replacement fund is necessary, and

(B) A ruling to that effect is subsequently issued to the issuer (before or after the date of issuance of the obligations).

The procedure set forth in the preceding sentence does not preclude an issuer from relying on a published ruling in which the Commissioner specifically designates a category of reserve or replacement funds as reasonably required for refunding issues.

(6) *Adjusted maturity date.* (i) The adjusted maturity date of a prior issue is the earlier of—

(A) The maturity date, or

(B) The expected call date (provided that the expected call date is not unreasonably early).

(ii) If different parts of the prior issue have different adjusted maturity dates, then (solely for purposes of paragraph (e) (4) and (5) of this section) those different parts shall be treated as separate issues and the amount of any proceeds of the prior issue shall be allocated among the different parts in the same proportion as each part bears to the total outstanding principal amount of the prior issue. If parts of a prior issue are treated as separate issues under the preceding sentence, and if the proceeds of the refunding issue are used to refund two or more such parts, then (solely for purposes of paragraph (e) (4) and (5) of this section) the portion of the proceeds of the refunding issue used to refund each such part of the prior issue shall be treated as a separate refunding issue.

(7) *Exception.* (i) Section 1.103-14(e)(5)(i)(B) does not apply to amounts deposited in a reserve or replacement fund for a refunding issue to the extent that such amounts—

(A) Were held in a reasonably required reserve or replacement fund for the prior issue, or

(B) Would (but for the refunding) have been deposited in a reasonably required reserve or replacement fund for the prior issue.

(ii) The following examples illustrate the application of this subparagraph:

Example (1). On July 1, 1987, city A issues $10 million of revenue bonds. No reserve or replacement fund is created for the revenue bonds. On July 1, 1989, city A issues $11 million of refunding bonds to defease the 1987 issue. City A accumulates a reserve fund of $800,000 for the 1989 issue. This reserve fund is pledged as collateral for the 1989 issue, and city A is unable to make withdrawals from the reserve fund at any time during the term of the 1989 issue (except to pay debt service on the 1989 issue). Assume that the entire 1987 issue will be called on July 1, 1997, and no portion of the 1987 issue will be retired before that date. Based on these facts, the proceeds of the 1989 issue replace amounts held in the reserve fund within the meaning of section 103(c)(2)(B). Therefore, these amounts are subject to the same yield restrictions, and generally have the same status, as proceeds of the 1989 issue. As a result, the revenues deposited in the reserve fund are subject to arbitrage yield restrictions until July 1, 1997

(see § 1.103-14(e)(5)(i)(B)) unless city A makes the demonstration required by § 1.103-14(e)(5)(iii). The result is the same whether or not city A reasonably expects to use amounts held in the reserve fund to pay debt service on the 1989 issue.

Example (2). On January 1, 1988, city B issues $10 million of revenue bonds. Under the bond indenture, city B is required to deposit revenues of $200,000 a year for 5 years in a reasonably required reserve fund for the 1988 issue (the "1988 reserve"). On January 1, 1990, city B issues $11 million of refunding bonds to defease the 1988 issue. At that time, city B transfers the $400,000 accumulated in the 1988 reserve to a reasonably required reserve fund for the 1990 issue (the "1990 reserve"). In addition, city B deposits revenues of $200,000 a year in the 1990 reserve for the next 3 years. Based on these facts, the amounts held in the 1990 reserve may be invested at an unrestricted yield pursuant to § 1.103-14(d).

[T.D. 7627, 44 FR 32669, June 7, 1979; 44 FR 64405, Nov. 7, 1979]

§ 1.103-15 Excess proceeds.

(a) *General rule.* If the excess proceeds (as defined in paragraph (b) of this section) of a refunding issue exceed 1 percent of the original proceeds, then (except as provided in paragraphs (c), (d), (e), and (f) of this section) the refunding obligations are arbitrage bonds.

(b) *Excess proceeds*—(1) *In general.* For purposes of this section, the "excess proceeds" of a refunding issue are all proceeds (including investment proceeds) other than:

(i) Proceeds that will be used to pay principal, interest, or call premium on the prior issue;

(ii) Proceeds that will be used to pay not more than 6 months' accrued interest on the refunding issue;

(iii) Proceeds that will be used to pay capitalized interest (as defined in subparagraph (2) of this paragraph) on the refunding issue;

(iv) Proceeds that will be used as part of a reasonably required reserve or replacement fund for the refunding issue;

(v) Proceeds that will be used to pay the administrative costs of—

(A) Repaying the prior issue,

(B) Carrying and repaying the refunding issue, or

(C) Purchasing, carrying, and selling or redeeming obligations acquired with the proceeds of the refunding issue;

(vi) Transferred proceeds that will be used for the purpose of the prior issue;

(vii) Investment proceeds derived from the investment of a reasonably required reserve or replacement fund;

(viii) Interest on acquired purpose obligations; and

(ix) Amounts treated as proceeds solely because they are accumulated in a sinking fund for the refunding issue (see § 1.103-13(g)).

(2) *Capitalized interest.* For purposes of subparagraph (1) of this paragraph, "capitalized interest" means interest on a refunding issue that accrues within—

(i) The period of time necessary to complete the construction or acquisition of the project for which the prior issue was issued, plus

(ii)(A) One year, or

(B) A period not longer than 5 years if, prior to the issuance of the refunding issue, the issuer demonstrates to the satisfaction of the Commissioner that, because of inadequate revenues during the commencement of operations of the project, interest which accrues during that period should be treated as capitalized interest.

(c) *First exception: gross refunding*—(1) *In general.* If a refunding issue (hereinafter called the "series B issue") is used together with one or more other refunding issues (hereinafter called the "series A issues") in a gross refunding of a prior issue and if all five of the requirements set out in subparagraph (2) of this paragraph are satisfied, then this section shall not apply to the series B issue or the series A issues.

(2) *Requirements.* The requirements referred to in subparagraph (1) of this paragraph are as follows:

(i) Substantially all of the excess proceeds of the series B issue and substantially all of the excess proceeds of each series A issue will be used to pay principal and interest on the series B issue. (For the meaning of "substantially all", see paragraph (d)(2) of this section.)

(ii) Substantially all of the excess proceeds of the series B issue and substantially all of the excess proceeds of

each series A issue will be investment proceeds.

(iii) At least 99 percent of all principal and interest on the series B issue will be paid with proceeds of the series B and series A issues or with the earnings on other amounts put into escrow to discharge the prior issue.

(iv) The series B issue will not be discharged later than the prior issue.

(v) At no time will the proceeds of the series B issue which have been spent exceed the sum of the payments made on or before that time of—

(A) Principal and interest on the series B issue, and

(B) Administrative costs of the series B issue described in paragraph (b)(1)(v) (B) and (C) of this section.

(d) *Second exception: crossover refunding*—(1) *In general.* This section shall not apply to a refunding issue if both of the following requirements are satisfied:

(i) Substantially all of the excess proceeds of the refunding issue will be used to pay interest that accrues on the refunding issue before the prior issue is discharged.

(ii) No proceeds of any refunding issue will be used to pay interest on the prior issue or to replace funds that are used directly or indirectly to pay such interest.

(2) *Substantially all.* For purposes of paragraphs (c)(2) and (d)(1) of this section, "substantially all" of the excess proceeds of a refunding issue means all of the excess proceeds except for an amount not larger than 1 percent of the original proceeds.

(e) *Third exception: prior ruling*—(1) *In general.* This section shall not apply to a refunding issue if, prior to the issuance of the refunding issue, the issuer demonstrates to the satisfaction of the Commissioner that it will not realize any material debt service or other savings directly or indirectly from the receipt of excess proceeds amounting to more than 1 percent of the original proceeds of the issue.

(2) *Material.* For purposes of this paragraph—

(i) A debt service or other savings is material if it has a present value of more than $100 on the day the refunding issue is sold;

(ii) In determining the present value of any debt service or other savings, the yield on the refunding issue (as determined under § 1.103-13(c)(2)(ii)) shall be used as the discount rate.

(f) *Fourth exception: temporary period.* This section shall not apply to a refunding issue if the prior issue is discharged within 180 days after the refunding bonds are issued.

(g) *Special rule.* If the original proceeds of a refunding issue are less than $500,000, then "$5,000" shall be substituted for "1 percent of the original proceeds" in paragraphs (a) and (d)(2) of this section and for "1 percent of the original proceeds of the issue" in paragraph (e)(1) of this section.

(h) *Meaning of terms.* The terms used in this section have the same meaning as in §§ 1.103-13 and 1.103-14.

(i) *Transferred proceeds.* For purposes of this section, all original proceeds, investment proceeds, and transferred proceeds of the prior issue are treated as transferred proceeds of the refunding issue, except for amounts spent before the refunding bonds are issued.

(j) *Illustrations.* For purposes of this paragraph, it is assumed that city A has outstanding $10 million of noncallable 9-percent revenue bonds (the "prior issue") due on January 1, 1990. Principal and interest on the prior issue are payable solely from revenues of the city A water works. In order to modify restrictions in the bond indenture, city A contemplates refunding the prior issue on January 1, 1983. To that end, city A takes under consideration four different advance refunding programs:

Example (1). The first refunding program contemplates a standard defeasance of the prior issue. In this first program, city A would issue $11,500,000 of 7-percent refunding bonds at par on January 1, 1983. The refunding bonds would mature on January 1, 1990 and would be paid solely from revenues of the city A water works. The original proceeds of the refunding bonds would be $11,435,000 (*i.e.*, $11,500,000 less issuing expenses of $65,000) and the investment proceeds (derived from investment in 6.5-percent Treasury obligations) would be $4,916,820. Of the total $16,351,820 of proceeds, $10,000,000 would be used to pay principal on the prior issue, $6,300,000 would be

used to pay interest on the prior issue, $35,000 would be used to pay administrative costs of purchasing, carrying, and redeeming acquired obligations, $10,000 would be used to pay administrative costs of carrying and repaying the refunding bonds, and the remaining $6,820 would be used to pay principal on the refunding bonds. Based on these assumptions, the excess proceeds of the refunding issue (*i.e.*, $6,820) would be less than 1 percent of the original proceeds (*i.e.*, .01×$11,435,000=$114,350). Therefore, the refunding bonds would not be treated as arbitrage bonds under this section. (See paragraph (a) of this section.)

Example (2). The second refunding program contemplates a full cash defeasance of the prior issue. In this second program, city A would issue $11,135,000 of series A revenue bonds and $5,320,000 of series B special obligation bonds at par on January 1, 1983. The series A bonds would bear a 7-percent coupon, would mature on January 1, 1990, and would be paid solely from revenues of the city A water works. The series B bonds would bear a 4-percent coupon, would be paid solely out of earnings on amounts put into escrow to defease the prior issue, and would mature according to the following schedule:

July 1, 1983	$410,000
January 1, 1984	430,000
July 1, 1984	410,000
January 1, 1985	405,000
July 1, 1985	395,000
January 1, 1986	395,000
July 1, 1986	385,000
January 1, 1987	375,000
July 1, 1987	370,000
January 1, 1988	365,000
July 1, 1988	355,000
January 1, 1989	350,000
July 1, 1989	340,000
January 1, 1990	335,000

The yield on the series B bonds (computed separately) would be approximately 4¼ percent (see § 1.103-13(c)). The proceeds of both the series A and series B issues would be invested in United States Treasury obligations paying 6.5 percent. Even though the combined yield on the series A and series B issues would be somewhat greater than 6.5 percent, the series B bonds would be arbitrage bonds.

Example (3). The third refunding program also contemplates a full cash defeasance of the prior issue. In this third refunding program, city A would issue $16,455, 000 of 6⅜-percent refunding bonds at par on January 1, 1983. The 6⅜-percent refunding bonds would be an amalgamation of the series A and B refunding bonds described in example (2) of this paragraph. The 6⅜-percent refunding bonds would be paid partly from revenues of the city A water works and partly from earnings on amounts put into escrow to defease the prior issue. They would mature according to the following schedule:

July 1, 1983	$410,000
January 1, 1984	430,000
July 1, 1984	410,000
January 1, 1985	405,000
July 1, 1985	395,000
January 1, 1986	395,000
July 1, 1986	385,000
January 1, 1987	375,000
July 1, 1987	370,000
January 1, 1988	365,000
July 1, 1988	355,000
January 1, 1989	350,000
July 1, 1989	340,000
January 1, 1990	11,470,000

The original proceeds of this 6⅜-percent refunding issue would be $16,355,000 (*i.e.*, $16,455,000 less issuing expenses of $100,000) and the investment proceeds (derived from investment in 6.5 percent Treasury obligations) would be $6,085,625. Of the total $22,440,625 of proceeds, $10,000,000 would be used to pay principal on the prior issue, $6,300,000 would be used to pay interest on the prior issue, $50,000 would be used to pay administrative costs of purchasing, carrying, and redeeming acquired obligations, $767,100 would be used to pay interest on the refunding bonds, and the remaining $5,323,525 would be used to pay principal on the refunding bonds. Based on these assumptions, the excess proceeds of the 6⅜-percent refunding issue would be $6,090,625 (*i.e.*, $767,100 + $5,323,525), which is $5,927,075 more than the amount permitted under paragraph (a) of this section (*i.e.*, 1 percent of the original proceeds = .01 × $16,355,000 = $163,550). City A would realize a debt service savings of approximately $115,000 by using the 6⅜-percent refunding bonds to refund the prior issue instead of using the 7-percent refunding bonds described in example (1) of this paragraph. Moreover, at least $101 of the $115,000 savings would result from city A's receipt of $5,927,075 of impermissible excess proceeds. Therefore, the 6⅜-percent refunding bonds would not come within the exception in paragraph (e) of this section. Because the 6⅜-percent refunding bonds would also fail to come within the exceptions in paragraphs (c) and (d) of this section, they would be arbitrage bonds.

Example (4). (a) The fourth refunding program also contemplated a full cash defeasance of the prior issue. In this fourth refunding program, city A would issue $11,500,000 of series A revenue bonds and $4,950,000 of series B special obligation bonds at par on January 1, 1983. The series A bonds would bear a 7-percent coupon, would mature on January 1, 1990, and would be paid solely from revenues of the

city A water works. The series B bonds would bear a 4-percent coupon, would be paid solely out of earnings on amounts put into escrow to discharge the prior issue, and would mature as shown in column C of Table II (see item (b) of this example).

(b) Table I shows receipts and payments of proceeds of the series A issue. Table II shows receipts and payments of proceeds of the Series B issue. For explanatory notes, see item (c) of this example.

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TABLE I

A	B	C	D	E	F
Date	Original proceeds spent	Investment proceeds spent	Administrative costs	Remaining proceeds	Cash balance
1-1-83	$35,000	0	$35,000	$11,400,000	0
7-1-83	79,500	$370,500	0	11,320,500	0
1-1-84	83,084	367,916	1,000	11,237,400	$16
7-1-84	84,785	365,215	0	11,152,600	31
1-1-85	88,541	362,459	1,000	11,064,000	90
7-1-85	90,420	359,580	0	10,973,600	70
1-1-86	94,358	356,642	1,000	10,879,300	12
7-1-86	96,423	353,577	0	10,782,800	89
1-1-87	100,559	350,441	1,000	10,682,300	30
7-1-87	102,825	347,175	0	10,579,500	5
1-1-88	107,166	343,834	1,000	10,472,300	39
7-1-88	109,650	340,350	0	10,362,600	89
1-1-89	114,216	336,784	1,000	10,248,400	73
7-1-89	116,927	333,073	0	10,131,500	46
1-1-90	10,131,546	329,274	4,000	0	0

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TABLE II—Continued

A	B	C	D	E	F	G	H	I
Date	Interest paid on series B issue	Principal paid on series B issue	Investment proceeds spent	Original proceeds spent	Administrative costs	Remaining proceeds	Cash balance	Outstanding principal amount of series B issue
1-1-83	0	0	0	$15,000	$15,000	$4,900,000	0	$4,950,000
7-1-83	99,000	$375,000	$103,500	370,500	0	4,529,500	$2,954	4,575,000
1-1-84	91,500	375,000	100,584	366,916	1,000	4,162,500	859	4,200,000
7-1-84	84,000	370,000	88,785	365,215	0	3,797,300	2,491	3,830,000
1-1-85	76,600	365,000	81,141	361,459	1,000	3,435,900	3,788	3,465,000
7-1-85	69,300	365,000	74,720	359,580	0	3,076,300	3,734	3,100,000
1-1-86	62,000	360,000	67,358	355,642	1,000	2,720,600	3,268	2,740,000
7-1-86	54,800	360,000	61,223	353,577	0	2,367,100	1,074	2,380,000
1-1-87	47,600	350,000	49,159	349,441	1,000	2,017,600	3,400	2,030,000
7-1-87	40,600	350,000	43,425	347,175	0	1,670,400	3,833	1,680,000
1-1-88	33,600	345,000	36,766	342,834	1,000	1,327,600	3,323	1,335,000
7-1-88	26,700	345,000	31,350	340,350	0	987,300	766	990,000
1-1-89	19,800	335,000	20,016	335,784	1,000	651,500	2,215	655,000
7-1-89	13,100	335,000	15,027	333,073	0	318,400	1,369	320,000
1-1-90	6,400	320,000	8,232	318,454	1,000	0	0	0

(c) The following notes explain Tables I and II in item (b) of this example:

(1) Column B of Table I shows when the original proceeds of the series A issue would be spent. The original proceeds would be $11,435,000 (*i.e.*, $11,500,000 less issuing expenses of $65,000). Of these original proceeds, $10,000,000 would be used to pay principal on the prior issue, $1,400,000 would be used to pay interest on the prior issue, and the remaining $35,000 would be used to pay administrative costs of investing the proceeds of the series A issue.

(2) Column C of Table I shows when the investment proceeds of the series A issue would be spent. (All these investment proceeds would be spent at the same time they were received.) Of the $4,916,820 of investment proceeds, $10,000 would be used to pay administrative costs of carrying and repaying the series A issue, $4,900,714 (which would be excess proceeds) would be used to pay principal and interest on the series B issue, and the remaining $6,106 would be used to pay principal on the series A issue. These investment proceeds would be derived from investing the original proceeds of the series A issue in 6½-percent Treasury obligations. (It is assumed that 6½ percent is the highest rate that the Treasury will pay on January 1, 1983.)

(3) Column D of Table I shows administrative costs of carrying the series A issue and of investing the proceeds of the series A issue. These administrative costs would be paid with proceeds of the series A issue.

(4) Column E of Table I shows the amount of original proceeds of the series A issue that would be invested in Treasury obligations as of the end of the corresponding day in column A.

(5) Column F of Table I shows small amounts of original proceeds that would be kept in a checking account. These amounts would be temporary investments (see § 1.103-14(e)(3)(ix)).

(6) Column B of Table II shows the interest that would be paid on the series B issue.

(7) Column C of Table II shows the principal that would be paid on the series B issue.

(8) Column D of Table II shows when the investment proceeds of the series B issue would be spent. (Not all these investment proceeds would be spent at the same time they were received. Some would be put into the checking account described in item (c)(12) of this example.) Of the $781,286 of investment proceeds, $7,000 would be used to pay administrative costs of carrying and repaying the series B issue, and the remaining $774,286 (which would be excess proceeds) would be used to pay principal and interest on the series B issue. These investment proceeds would be derived from investing the original proceeds of the series B issue in 4.345-percent Treasury obligations. (However, the yield on the acquired obligations, taking into account $15,000 of administrative costs paid on January 1, 1983, would be only 4.252 percent. The yield on the series B issue would also be 4.252 percent.)

(9) Column E of Table II shows when the original proceeds of the series B issue would be spent. The original proceeds would be $4,915,000 (*i.e.*, $4,950,000 less issuing expenses of $35,000). All these original proceeds would be used to pay interest on the prior issue except for $15,000 that would be used to pay administrative costs of investing the original proceeds of the series B issue.

(10) Column F of Table II shows administrative costs of carrying and repaying the series B issue and investing the proceeds of the series B issue. These administrative costs would be paid with investment proceeds of the series B issue.

(11) Column G of Table II shows the amount of original proceeds of the series B issue that would be invested in Treasury obligations as of the end of the corresponding day in column A.

(12) Column H of Table II shows small amounts of original and investment proceeds of the series B issue that would be kept in a checking account. These amounts would be temporary investments (see § 1.103-14(e)(3)(ix)).

(d) Based on items (a), (b), and (c) of this example, the following conclusions may be drawn:

(1) All of the excess proceeds of the series B issue and substantially all (*i.e.*, all but $6,106) of the excess proceeds of the series A issue would be used to pay principal and interest on the series B issue.

(2) All of the excess proceeds of the series B and series A issues would be investment proceeds.

(3) All of the principal and interest on the series B issue would be paid with proceeds of the series B and series A issues.

(4) The series B issue would be discharged on January 1, 1990, the same day as the prior issue.

(5) The proceeds of the series B issue would not be spent faster than principal and interest on the series B issue and administrative costs of the series B issue would be paid. For example, on January 1, 1984, $956,500 of proceeds of the series B would have been spent (*i.e.*, $752,416 of original proceeds plus $204,084 of investment proceeds), which is the same as the $956,500 of principal, interest, and administrative costs of the series B issue that would be paid on or before January 1, 1984 (*i.e.*, $750,000 of principal plus $190,500 of interest plus $16,000 of administrative costs).

(e) Based on the conclusions in item (d) of this example, the series A and series B bonds are not treated as arbitrage bonds

under this section (see paragraph (c) of this section).

[T.D. 7627, 44 FR 32678, June 7, 1979]

§ 1.104-1 Compensation for injuries or sickness.

(a) *In general.* Section 104(a) provides an exclusion from gross income with respect to certain amounts described in paragraphs (b), (c), (d) and (e) of this section, which are received for personal injuries or sickness, except to the extent that such amounts are attributable to (but not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year. See section 213 and the regulations thereunder.

(b) *Amounts received under workmen's compensation acts.* Section 104(a)(1) excludes from gross income amounts which are received by an employee under a workmen's compensation act (such as the Longshoremen's and Harbor Workers' Compensation Act, 33 U.S.C., c. 18), or under a statute in the nature of a workmen's compensation act which provides compensation to employees for personal injuries or sickness incurred in the course of employment. Section 104(a)(1) also applies to compensation which is paid under a workmen's compensation act to the survivor or survivors of a deceased employee. However, section 104(a)(1) does not apply to a retirement pension or annuity to the extent that it is determined by reference to the employee's age or length of service, or the employee's prior contributions, even though the employee's retirement is occasioned by an occupational injury or sickness. Section 104(a)(1) also does not apply to amounts which are received as compensation for a nonoccupational injury or sickness nor to amounts received as compensation for an occupational injury or sickness to the extent that they are in excess of the amount provided in the applicable workmen's compensation act or acts. See, however, §§ 1.105-1 through 1.105-5 for rules relating to exclusion of such amounts from gross income.

(c) *Damages received on account of personal injuries or sickness.* Section 104(a)(2) excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. The term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.

(d) *Accident or health insurance.* Section 104(a)(3) excludes from gross income amounts received through accident or health insurance for personal injuries or sickness (other than amounts received by an employee, to the extent that such amounts (1) are attributable to contributions of the employer which were not includible in the gross income of the employee, or (2) are paid by the employer). Similar treatment is also accorded to amounts received under accident or health plans and amounts received from sickness or disability funds. See section 105(e) and § 1.105-5. If, therefore, an individual purchases a policy accident or health insurance out of his own funds, amounts received thereunder for personal injuries or sickness are excludable from his gross income under section 104(a)(3). See, however, section 213 and the regulations thereunder as to the inclusion in gross income of amounts attributable to deductions allowed under section 213 for any prior taxable year. Section 104(a)(3) also applies to amounts received by an employee for personal injuries or sickness from a fund which is maintained exclusively by employee contributions. Conversely, if an employer is either the sole contributor to such a fund, or is the sole purchaser of a policy of accident or health insurance for his employees (on either a group or individual basis), the exclusion provided under section 104(a)(3) does not apply to any amounts received by his employees through such fund or insurance. If the employer and his employees contribute to a fund or purchase insurance which pays accident or health benefits to employees, section 104(a)(3) does not apply to amounts received thereunder by employees to the extent that such amounts are attributable to the em-

ployer's contributions. See § 1.105-1 for rules relating to the determination of the amount attributable to employer contributions. Although amounts paid by or on behalf of an employer to an employee for personal injuries or sickness are not excludable from the employee's gross income under section 104(a)(3), they may be excludable therefrom under section 105. See §§ 1.105-1 through 1.105-5, inclusive. For treatment of accident or health benefits paid to or on behalf of a self-employed individual by a trust described in section 401(a) which is exempt under section 501(a) or under a plan described in section 403(a), see paragraph (g) of § 1.72-15.

(e) *Amounts received as pensions, etc., for certain personal injuries or sickness.* (1) Section 104(a)(4) excludes from gross income amounts which are received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country, or in the Coast and Geodetic Survey, or the Public Health Service. For purposes of this section, that part of the retired pay of a member of an armed force, computed under formula No. 1 or 2 of 10 U.S.C. 1401, or under 10 U.S.C. 1402(d), on the basis of years of service, which exceeds the retired pay that he would receive if it were computed on the basis of percentage of disability is not considered as a pension, annuity, or similar allowance for personal injury or sickness, resulting from active service in the armed forces of any country, or in the Coast and Geodetic Survey, or the Public Health Service (see 10 U.S.C. 1403 (formerly 37 U.S.C. 272(h), section 402(h) of the Career Compensation Act of 1949)). See paragraph (a)(3)(i)(*a*) of § 1.105-4 for the treatment of retired pay in excess of the part computed on the basis of percentage of disability as amounts received through a wage continuation plan. For the rules relating to certain reduced uniformed services retirement pay, see paragraph (c)(2) of § 1.122-1. For rules relating to a waiver by a member or former member of the uniformed services of a portion of disability retired pay in favor of a pension or compensation receivable under the laws administered by the Veterans Administration (38 U.S.C. 3105), see § 1.122-1(c)(3). For rules relating to a reduction of the disability retired pay of a member or former member of the uniformed services under the Dual Compensation Act of 1964 (5 U.S.C. 5531) by reason of Federal employment, see § 1.122-1(c)(4).

(2) Section 104(a)(4) excludes from gross income amounts which are received by a participant in the Foreign Service Retirement and Disability System in a taxable year of such participant ending after September 8, 1960, as a disability annuity payable under the provisions of section 831 of the Foreign Service Act of 1946, as amended (22 U.S.C. 1081; 60 Stat. 1021). However, if any amount is received by a survivor of a disabled or incapacitated participant, such amount is not excluded from gross income by reason of the provisions of section 104(a)(4).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6722, 29 FR 5070, Apr. 14, 1964; T.D. 7043, 35 FR 8477, June 2, 1970]

§ 1.105-1 Amounts attributable to employer contributions.

(a) *In general.* Under section 105(a), amounts received by an employee through accident or health insurance for personal injuries or sickness must be included in his gross income to the extent that such amounts (1) are attributable to contributions of the employer which were not includible in the gross income of the employee, or (2) are paid by the employer, unless such amounts are excluded therefrom under section 105(b), (c), or (d). For purposes of this section, the term "amounts received by an employee through an accident or health plan" refers to any amounts received through accident or health insurance, and also to any amounts which, under section 105(e), are treated as being so received. See § 1.105-5. In determining the extent to which amounts received for personal injuries or sickness by an employee through an accident or health plan are subject to the provisions of section 105(a), rather than section 104(a)(3), the provisions of paragraphs (b), (c), (d), and (e) of this section shall apply. A self-employed

individual is not an employee for purposes of section 105 and §§ 1.105-1 through 1.105-5. See paragraph (g) of § 1.72-15. Thus, such an individual will not be treated as an employee with respect to benefits described in section 105 received from a plan in which he participates as an employee within the meaning of section 401(c)(1) at the time he, his spouse, or any of his dependents becomes entitled to receive such benefits.

(b) *Noncontributory plans.* All amounts received by employees through an accident or health plan which is financed solely by their employer, either by payment of premiums on an accident or health insurance policy (whether on a group or individual basis), by contributions to a fund which pays accident or health benefits, or by direct payment of the benefits under the plan, are subject to the provisions of section 105(a), except to the extent that they are excludable under section 105(b), (c), or (d). This rule may be illustrated by the following examples:

Example (1). Employer A maintains a plan for his employees which provides that he will continue to pay regular wages to employees who are absent from work due to sickness or personal injuries. Employees make no contributions to the plan and all benefits are paid by the employer. Amounts received by employees under the plan are subject to section 105(a), and must be included in gross income unless excluded therefrom under section 105(b), (c), or (d).

Example (2). Pursuant to a State nonoccupational disability benefits law, employer B maintains an accident and health plan for his employees. Although under the State law B is authorized to withhold from his employees' wages a specified amount for employee contributions to the State fund, in actual practice B does not so withhold and makes all contributions out of his own funds. All amounts received by B's employees from the State fund are subject to section 105(a), and must be included in gross income unless excluded therefrom under section 105 (b), (c), or (d).

(c) *Contributory plans.* (1) In the case of amounts received by an employee through an accident or health plan which is financed partially by his employer and partially by contributions of the employee, section 105(a) applies to the extent that such amounts are attributable to contributions of the employer which were not includible in the employee's gross income. The portion of such amounts which is attributable to such contributions of the employer shall be determined in accordance with paragraph (d) of this section in the case of an insured plan, or paragraph (e) of this section in the case of a noninsured plan. As used in this section, the phrase "contributions of the employer" means employer contributions which were not includible in the gross income of the employee. See section 106 for the exclusion from an employee's gross income of employer contributions to accident or health plans.

(2) A separate determination of the portion of the amounts received under the accident or health plan which is attributable to the contributions of the employer shall be made with respect to each class of employees in any case where the plan provides that some classes of covered employees contribute but others do not, or that the employer will make different contributions for different classes of employees, or that different classes of employees will make different contributions, and where in any such case both the contributions of the employer on account of each such class of employees and the contributions of such class of employees can be ascertained. For example, if employees contribute during the first year of employment but not thereafter, there will have to be a separate determination for first year employees, provided that the amount of the contributions of the employer on account of first-year employees and the contributions of such first-year employees can be ascertained for the required periods to apply the rules of paragraph (d) or (e) of this section. If in such a case the contributions of the employer to the plan on account of first-year employees are not distinguishable from his other contributions to the plan, then the determination shall be made for all employees under the plan, and such determination shall be used by all employees under the plan.

(3) Except as provided in paragraph (c)(2) of § 1.72-15, if the plan provides accident or health benefits as well as other benefits for the employees, and

if the respective contributions made by the employer and the employees to provide the accident or health benefits cannot be ascertained, the determination of the portion of the accident or health benefits received under such plan which is attributable to the contributions of the employer shall be made in accordance with the rules of paragraph (d) or (e) of this section on the basis of the contributions of the employer and of the employees to the entire plan.

(4) A determination of the portion attributable to the contributions of the employer, once made in accordance with the rules of this section, shall as to such portion be used for all purposes. For example, if an employee receives amounts under a wage continuation plan during the month of January and terminates his services during February, the portion of such amounts which is attributable to the contributions of the employer may be determined in order to provide the employee with such information at the time he is provided his Form W-2. The determination made for such purpose will also be used by the employee to report his income for his taxable year in which such amounts are received, without regard to the experience under the plan for the rest of the year.

(d) *Insured plans*—(1) *Individual policies.* If an amount is received from an insurance company by an employee under an individual policy of accident or health insurance purchased by contributions of the employer and the employee, the portion of the amount received which is attributable to the employer's contributions shall be an amount which bears the same ratio to the amount received as the portion of the premiums paid by the employer for the current policy year bears to the total premiums paid by the employer and the employee for that year. This rule may be illustrated by the following example:

Example. Employer A maintains a plan whereby he pays two-thirds of the annual premium cost on individual policies of accident and health insurance for his employees. The remainder of each employee's premium is paid by a payroll deduction from the wages of the employee. The annual premium for employee X is $24, of which $16 is paid by the employer. Thus, 16/24 or two-thirds of all amounts received by X under such insurance policy are attributable to the contributions of the employer and are subject to section 105(a), and the remaining one-third of such amounts is excludable from X's gross income under section 104(a)(3).

(2) *Group policies.* If the accident or health coverage is provided under or is a part of a group insurance policy purchased by contributions of the employer and of the employees, and the net premiums for such coverage for a period of at least three policy years are known at the beginning of the calendar year, the portion of any amount received by an employee which is attributable to the contributions of the employer for such coverage shall be an amount which bears the same ratio to the amount received as the portion of the net premiums contributed by the employer for the last three policy years which are known at the beginning of the calendar year, bears to the total of the net premiums contributed by the employer and all employees for such policy years. If the net premiums for such coverage for a period of at least three policy years are not known at the beginning of the calendar year but are known for at least one policy year, such determination shall be made by using the net premiums for such coverage which are known at the beginning of the calendar year. If the net premiums for such coverage are not known at the beginning of the calendar year for even one policy year, such determination shall be made by using either (i) a reasonable estimate of the net premiums for the first policy year, or (ii) if the net premiums for a policy year are ascertained during the calendar year, by using such net premiums. These rules may be illustrated by the following example:

Example. An employer maintains a plan under which a portion of the cost of a group policy of accident and health insurance for his employees is paid through payroll deductions from wages of the employees. The remainder of the cost is borne by the employer. The policy year begins on November 1 and ends on October 31. The net premium for the policy year ended October 31, 1954, is not known on January 1, 1955, because certain retroactive premium adjustments,

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such as dividends and credits, are not determinable until after January 1. Therefore, for purposes of this computation the last three policy years are the policy years ended October 31, 1951, 1952, and 1953. The net premium for the policy year ended October 31, 1953, was $8,000, of which the employer contributed $3,000; the net premium for the policy year ended October 31, 1952, was $9,000, of which the employer contributed $3,500; and the net premium for the policy year ended October 31, 1951, was $7,000, of which the employer contributed $1,500. The portion of any amount received under the policy by an employee at any time during 1955 which is attributable to the contributions of the employer is to be determined by using the ratio of $8,000 ($3,000 plus $3,500 plus $1,500) to $24,000 ($8,000 plus $9,000 plus $7,000. Thus, $8,000 ÷ $24,000 or one-third, of the amounts received by an employee at any time during 1955 is attributable to contributions of the employer.

(e) *Noninsured plans.* If the accident or health benefits are a part of a noninsured plan to which the employer and the employees contribute, and such plan has been in effect for at least three years before the beginning of the calendar year, the portion of the amount received which is attributable to the employer's contributions shall be an amount which bears the same ratio to the amount received as the contributions of the employer for the period of three calendar years next preceding the year of receipt bear to the total contributions of the employer and all the employees for such period. If, at the beginning of the calendar year of receipt, such plan has not been in effect for three years but has been in effect for at least one year, such determination shall be based upon the contributions made during the 1-year or 2-year period during which the plan has been in effect. If such plan has not been in effect for one full year at the beginning of the calendar year of receipt, such determination may be based upon the portion of the year of receipt preceding the time when the determination is made, or such determination may be made periodically (such as monthly or quarterly) and used throughout the succeeding period. For example, if an employee terminates his services on April 15, 1955, and 1955 is the first year the plan has been in effect, such determination may be based upon the contributions of the employer and the employees during the period beginning with January 1 and ending with April 15, or during the month of March, or during the quarter consisting of January, February, and March.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6722, 29 FR 5071, Apr. 14, 1964]

§ 1.105–2 Amounts expended for medical care.

Section 105(b) provides an exclusion from gross income with respect to the amounts referred to in section 105(a) (see § 1.105–1) which are paid, directly or indirectly, to the taxpayer to reimburse him for expenses incurred for the medical care (as defined in section 213(e)) of the taxpayer, his spouse, and his dependents (as defined in section 152). However, the exclusion does not apply to amounts which are attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year. See section 213 and the regulations thereunder. Section 105(b) applies only to amounts which are paid specifically to reimburse the taxpayer for expenses incurred by him for the prescribed medical care. Thus, section 105(b) does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether or not he incurs expenses for medical care. For example, if under a wage continuation plan the taxpayer is entitled to regular wages during a period of absence from work due to sickness or injury, amounts received under such plan are not excludable from his gross income under section 105(b) even though the taxpayer may have incurred medical expenses during the period of illness. Such amounts may, however, be excludable from his gross income under section 105(d). See § 1.105–4. If the amounts are paid to the taxpayer solely to reimburse him for expenses which he incurred for the prescribed medical care, section 105(b) is applicable even though such amounts are paid without proof of the amount of the actual expenses incurred by the taxpayer, but section

105(b) is not applicable to the extent that such amounts exceed the amount of the actual expenses for such medical care. If the taxpayer incurs an obligation for medical care, payment to the obligee in discharge of such obligation shall constitute indirect payment to the taxpayer as reimbursement for medical care. Similarly, payment to or on behalf of the taxpayer's spouse or dependents shall constitute indirect payment to the taxpayer.

§ 1.105-3 Payments unrelated to absence from work.

Section 105(c) provides an exclusion from gross income with respect to the amounts referred to in section 105(a) to the extent that such amounts (a) constitute payments for the permanent loss or permanent loss of use of a member or function of the body, or the permanent disfigurement, of the taxpayer, his spouse, or a dependent (as defined in section 152), and (b) are computed with reference to the nature of the injury without regard to the period the employee is absent from work. Loss of use or disfigurement shall be considered permanent when it may reasonably be expected to continue for the life of the individual. For purposes of section 105(c), loss or loss of use of a member or function of the body includes the loss or loss of use of an appendage of the body, the loss of an eye, the loss of substantially all of the vision of an eye, and the loss of substantially all of the hearing in one or both ears. The term "disfigurement" shall be given a reasonable interpretation in the light of all the particular facts and circumstances. Section 105(c) does not apply if the amount of the benefits is determined by reference to the period the employee is absent from work. For example, if an employee is absent from work as a result of the loss of an arm, and under the accident and health plan established by his employer, he is to receive $125 a week so long as he is absent from work for a period not in excess of 52 weeks, section 105(c) is not applicable to such payments. See, however, section 105(d) and § 1.105-4. However, for purposes of section 105(c), it is immaterial whether an amount is paid in a lump sum or in installments. Section 105(c) does not apply to amounts which are treated as workmen's compensation under paragraph (b) of § 1.104-1, or to amounts paid by reason of the death of the employee (see section 101).

§ 1.105-4 Wage continuation plans.

(a) *In general.* (1) Subject to the limitations provided in this section, section 105(d) provides an exclusion from gross income with respect to amounts referred to in section 105(a) which are paid to an employee through a wage continuation plan and which constitute wages or payments in lieu of wages for a period during which the employee is absent from work on account of personal injuries or sickness.

(2) (i) Section 105(d) is applicable only if the wages or payments in lieu of wages are paid pursuant to a wage continuation plan. (See § 1.105-6 for special rules for employees retired before January 27, 1975). The term "wage continuation plan" means an accident or health plan, as defined in § 1.105-5, under which wages, or payments in lieu of wages, are paid to an employee for a period during which he is absent from work on account of a personal injury or sickness. Such term includes plans under which payments are continued as long as the employee is absent from work on account of personal injury or sickness. It includes plans under which there is a limitation on the period for which benefits will be paid, such as 13 or 26 weeks, and also plans under which benefits are continued until the employee is either able to return to work or reaches mandatory retirement age. Such term also includes a plan under which wages or payments in lieu of wages are paid to an employee who is absent from work on account of personal injury or sickness, even though the plan also provides that wages or payments in lieu of wages may be paid to an employee who is absent from work for reasons other than a personal injury or sickness.

(ii) Section 105(d) is applicable if, and only if, the employee is absent from work and such absence is due to a personal injury or sickness. Thus, if

an employer has a plan for continuing the wages of employees when they are absent from work, regardless of the cause of the absence from work, section 105(d) is applicable to any payments made under this plan to an employee whose absence from work is in fact due to a personal injury or sickness. On the other hand, although the terms of a plan provide that benefits are to be continued only as long as the employee is absent from work on account of a personal injury or sickness, section 105(d) does not apply to payments made to an employee for a period of absence from work where such absence is not in fact due to a personal injury or sickness.

(3)(i)(A) Section 105(d) applies only to amounts attributable to periods during which the employee would be at work were it not for a personal injury or sickness. Thus, an employee is not absent from work if he is not expected to work because, for example, he has reached mandatory retirement age. If a plan provides that an employee, who is absent from work on account of a personal injury or sickness, will receive a disability pension or annuity as long as he is disabled, section 105(d) is applicable to any payments that he receives under this plan before reaching mandatory retirement age, as defined in paragraph (a)(3)(i)(B) of this section. Thus, section 105(d) would not apply to the payments that an employee receives after reaching mandatory retirement age. The disability retired pay received by a member on the retired list pursuant to section 402 of the Career Compensation Act of 1949 (63 Stat. 802) or chapter 61 of title 10, United States Code (10 U.S.C. 1201 et seq.) which is in excess of the amounts excludable under section 104(a)(4) and paragraph (e) of § 1.104-1 shall be excluded from gross income subject to the limitations of section 105(d) and this section, if such pay is received before the member reaches mandatory retirement age. See § 1.72-15 for additional rules relating to the tax treatment of disability pensions. For the rules relating to certain reduced uniformed services retirement pay, see paragraph (c)(2) of § 1.122. For rules relating to a waiver by a member or former member of the uniformed services of a portion of disability retired pay in favor of a pension or compensation receivable under the laws administered by the Veterans Administration (38 U.S.C. 3105), see § 1.122-1(c)(3).

(B) The term "mandatory retirement age" as used in paragraph (a)(3)(i)(A) of this section means the age set by an employer for the mandatory retirement of employees in the class to which the taxpayer last belonged, unless such age has been set at an age higher than that at which it has been the practice of the employer to terminate, due to age, the services of such employees, or for purposes of tax avoidance. Where no age is set for mandatory retirement, such term means age 65, or, if higher, the age at which it has been the practice of the employer to terminate, due to age, the services of the class of employees to which the taxpayer last belonged.

(ii) Similarly, an employee who incurs a personal injury or sickness during his paid vacation is not allowed to exclude under section 105(d) any of the vacation pay which he receives, since he is not absent from work on account of the personal injury or sickness. Likewise, a teacher who becomes sick during the summer or other vacation period when he is not expected to teach, is not entitled to any exclusion under section 105(d) for the summer or vacation period. However, if an employee who would otherwise be at work during a particular period is absent from work and his absence is in fact due to a personal injury or sickness, a payment which he receives for such period under a wage continuation plan is subject to section 105(d).

(4) A period of absence from work shall commence the moment the employee first becomes absent from work and shall end the moment the employee first returns to work. However, the exclusion provided under section 105(d) is applicable only to payments attributable to a period of absence from work which is due to a personal injury or sickness, and to payments attributable to a period when the employee would have been at work but for such personal injury or sickness.

(5) For the purpose of section 105(d), whether an employee is absent from

work depends upon all the circumstances. For example, an employee, who is a farm hand and who lives upon the premises of his employer, is absent from work when he is unable to work even though he remains on the premises of his employer. A member of the Armed Forces, who on a particular day has no assigned duties but to stand ready for duty, is absent from work if he is unable to answer any duty call that may be made upon him. An employee is not absent from work when he performs any services for his employer at his usual place or places of employment, whether or not the services are the usual services performed by the employee. Furthermore, the employee is not absent from work when he performs substantial services for his employer, even though they are performed at a place other than his usual place of employment. Thus, if an employee returns to his usual place or places of employment and performs any services for his employer, he has returned to work, but if he merely holds occasional short conferences concerning his work with other employees or clients while hospitalized or at home recuperating, such conferences do not constitute a return to work.

(b) *Determination of amount attributable to period of absence.* The amount which is paid to an employee as wages or payments in lieu of wages for a period of absence from work due to a personal injury or sickness shall be determined by reference to the plan under which the amount is paid, and to the contract, statute, or regulation which provides the terms of the employment. However, unless the plan, contract, statute, or regulation provides otherwise, it will be presumed that no wages or plan benefits are attributable to days (or portions of days) which are not normal working days for the particular employee. Also, section 105(d) does not apply to amounts earned prior to or subsequent to the period of absence from work, even though received during such period. These rules may be illustrated by the following examples:

Example (1). Employee A, who receives regular wages of $70 per week, normally works five days (Monday through Friday) during each week. A is absent from work on a Friday and the succeeding Monday (two working days) on account of a personal injury, but receives his regular wages with respect to such period of absence under his employer's accident and health plan. Unless the plan of A's employer, or the contract, statute, or regulation under which A is employed, provides otherwise, it will be presumed that A is not paid with respect to nonworking days (Saturday and Sunday). Therefore, the amount received by A with respect to his period of absence from work due to injury is $28, which is two days regular wages. If the plan, or the employment contract, statute, or regulation had provided that wages were paid on a 7-day per week basis and that A must be available for call to work on Saturday and Sunday, A's daily wage would have been $10, and the amount attributable to the period of absence would have been $40 ($10 per day for four days).

Example (2). Employee B is a salesman who is paid on a commission basis. The employer purchases for B an accident and health insurance policy which provides that B shall receive $50 per week during any period (after a 7-day waiting period) that he is unable to work due to personal injuries or sickness. B incurs a personal injury and is incapacitated for two weeks. He receives $50 under the insurance policy with respect to the second week of absence. In addition, during the 2-week period of absence he receives a check for $40 from his employer as his commission on a sale which he made before becoming incapacitated. Section 105(d) applies to the $50 received through the insurance policy, but does not apply to the $40 commission which B earned prior to the period of absence from work.

(c) *Limitation in the case of absence from work due to sickness for periods commencing prior to January 1, 1964.* (1) In the case of a period of absence from work on account of sickness commencing prior to January 1, 1964, the exclusion provided by section 105(d) does not apply to amounts attributable to the first seven calendar days of each such period, unless the employee is hospitalized on account of sickness for at least one day during the period of absence from work. This 7-day rule applies to each period of absence from work because of sickness, regardless of the frequency of such absences or the closeness in time to any prior period of absence from work because of sickness. For example, employee A becomes absent from work because of sickness on Friday, October 4, 1963, and returns to work on the morning of

Monday, October 14, 1963. He suffers a relapse and again becomes absent from work on the afternoon of Monday, October 14, 1963. A's return to work on the morning of Monday, October 14, 1963, terminates the first period of absence from work because of sickness, and a new period of absence from work because of sickness begins on the afternoon of Monday, October 14, 1963. The 7-day limitation does not apply if the absence from work is due to personal injury. These rules may be illustrated by the following examples:

Example (1). Employee C normally works five days (Monday through Friday) during each week. On Saturday, October 5, 1963 (a nonworking day), C becomes sick and as a result, he does not return to work until Thursday, October 17, 1963. The period of absence from work due to sickness commences on Monday, October 7, 1963, and terminates when C returns to work on Thursday, October 17, 1963. If C is not hospitalized during such period of absence from work, section 105(d) does not apply to amounts which C receives under his employer's wage continuation plan attributable to the 7-day period commencing Monday, October 7, 1963, and ending Sunday, October 13, 1963, inclusive.

Example (2). Employee D incurs a personal injury which causes him to be absent from work two days. His regular wages are continued during this period in accordance with the wage continuation plan of his employer. Since D's absence from work was due to a personal injury, rather than a sickness, the 7-day waiting period does not apply, and, subject to the other requirements of section 105(d), D is entitled to an exclusion with respect to the amounts received under the employer's plan attributable to the 2-day period of absence.

(2) For the purpose of starting the 7-day waiting period, if the period of absence due to sickness commences after the start of a working day, the amount received with respect to the portion of such day that the employee is absent from work shall be considered the amount attributable to the first calendar day of the period of absence from work due to sickness. This rule may be illustrated by the following example:

Example. Employee E normally works from 9 a.m. until 5:30 p.m. on five days (Monday through Friday) during each week. From noon on Friday, September 6, 1963, until noon on Monday, September 16, 1963, E is absent from work on account of sickness but is not hospitalized at any time during this period. Section 105(d) does not apply to amounts received by E under his employer's wage continuation plan which are attributable to the calendar period beginning September 6, 1963, and ending September 12, 1963, inclusive. However, if the other requirements of section 105(d) are met, E may exclude from gross income amounts attributable to the period beginning September 13, 1963, and ending at noon on September 16, 1963, inclusive.

(3) If the absence from work is due to sickness, the amount attributable to the first seven calendar days of such absence includes all amounts paid for such seven calendar days, regardless of the number of work days included in such seven calendar days. For example, if one of such seven calendar days an employee would have worked two 8-hour shifts, the amount he is paid for the two shifts is considered to be an amount attributable to only one calendar day.

(4) An employee is considered to be hospitalized for one day only if he is admitted to and confined in a hospital as a bed patient for at least one hospital day. Entry into a hospital as an in-and-out patient does not constitute hospitalization for purposes of section 105(d). The same applies to mere entry into the outpatient ward or the emergency ward of a hospital.

(d) *Exclusion not applicable to the extent that amounts exceed a weekly rate of $100 for periods of absence commencing prior to January 1, 1964*—(1) *In general.* Amounts received under a wage continuation plan, attributable to periods of absence commencing before January 1, 1964, which are not excludable from gross income as being attributable to contributions of the employee (see § 1.105-1) must be included in gross income under section 105(d) to the extent that the weekly rate of such amounts exceeds $100. Thus, an employee, who receives $50 under his employer's wage continuation plan on account of his being absent from work for two days due to a personal injury, cannot exclude the entire $50 under section 105(d) if the weekly rate of such benefits exceeds $100. If an employee receives payments under a wage continuation plan for less than a full pay period, the ex-

cludability of such payments shall be determined under subparagraph (2) of this paragraph. In all other cases, the weekly rate and excludability of such payments under a wage continuation plan shall be determined under subparagraph (3) of this paragraph. If, with respect to any pay period or portion thereof, the employee receives amounts under two or more wage continuation plans (whether such plans are maintained by or for the same employer or by different employers), the weekly rate and excludability of amounts received under each plan shall be determined under subparagraph (3) of this paragraph and the weekly rate for purposes of section 105(d) shall be the sum of all such weekly rates. This rule may be illustrated by the following examples:

Example (1). An employee whose weekly salary is $120 is covered by two wage continuation plans maintained by his employer. Plan A is a contributory insured plan to which the employee contributes 60 percent of the premiums and which provides a weekly payment of $30. Plan B is a salary continuation plan completely financed by the employer. Since 60 percent of the cost of plan A is contributed by the employee, 60 percent of the weekly payment of $30 ($18) is excluded from gross income under section 104(a)(3). The remainder of each weekly payment ($12) is the weekly rate of plan A. Since the employer pays the entire cost of plan B, the weekly rate of this plan is the total amount paid per week. In the case of an employee whose weekly wages of $120 are continued under plan B, the weekly rate for the employee for purposes of section 105(d) is $132 ($120 from plan B, plus $12 from plan A).

Example (2). Assume in Example (1) that plan A provides a waiting period of four calendar days while plan B is effective immediately. For the first four days of absence the weekly rate for purposes of section 105(d) is $120, and for periods after the first four days the weekly rate for purposes of section 105(d) is $132.

(2) *Daily exclusion.* If an employee receives payments under a wage continuation plan for less than a full pay period, the extent to which such benefits are excludable under section 105(d) shall be determined by computing the daily rate of the benefits which can be excluded under section 105(d). Such daily rate is determined by dividing the weekly rate at which wage continuation payments are excludable ($100) by the number of work days in a normal work week. This rule may be illustrated by the following example:

Example. Employee E is covered by a wage continuation plan maintained by his employer providing that E's regular salary of $220 semimonthly will be continued in case he is absent from work on account of a personal injury or sickness. E is absent from work on account of a personal injury for three days and under the plan he received $66 as wage continuation payments. The extent to which the $66 is excludable under section 105(d) shall be determined by dividing $100 by 5, the number of work days in a normal work week for E, resulting in a daily exclusion of $20 and a total exclusion of $60.

(3) *Determination of weekly rate at which amounts are paid under a wage continuation plan.* (i) For purposes of this subparagraph the pay period of a particular wage continuation plan shall be determined by reference to such plan. If, in the usual operation of the plan, benefits are paid for the same periods as regular wages, then the pay period of such benefits shall be the period for which a payment of wages is ordinarily made to the employee by the employer. If plan benefits are ordinarily paid for different periods than regular wages then the pay period of such benefits shall be the period for which payment of such benefits is ordinarily made.

(ii) The weekly rate shall be determined in accordance with the following rules:

(*a*) *Weekly pay period.* If benefits are paid on the basis of a weekly pay period, the weekly rate at which such benefits are paid shall be the weekly amount of such benefits.

(*b*) *Biweekly pay period.* If benefits are paid on the basis of a biweekly pay period, the weekly rate at which such benefits are paid shall be one-half of the biweekly rate.

(*c*) *Semimonthly pay period.* If benefits are paid on the basis of a semimonthly pay period, the weekly rate at which such benefits are paid shall be the semimonthly rate multiplied by 24 and divided by 52.

(*d*) *Monthly pay period.* If benefits are paid on the basis of a monthly pay period, the weekly rate at which such

benefits are paid shall be the monthly rate multiplied by 12 and divided by 52.

(e) *Other pay periods.* If benefits are paid on the basis of a period other than a period described in (a) through (d), of this subdivision the weekly rate at which such benefits are paid shall be determined by ascertaining the annual rate at which such benefits are paid and dividing such annual rate by 52.

(f) *Examples.* The operation of the rules of this subdivision may be illustrated by the following examples:

Example (1). A's employer maintains a noncontributory plan which provides for the continuation of regular salary during periods of absence from work due to personal injury or sickness. A, an office employee, receives regular salary of $520 per month, and he is paid on the basis of a monthly pay period. Since benefits under the salary continuation plan are paid for the same periods as regular salary, the pay period of the plan is monthly. For purposes of section 105(d), the weekly rate at which benefits are paid to A under the plan is $120, determined as follows:

$520 (monthly rate) × 12	$6,240 (annual rate)
$6,240 ÷ 52	$120 (weekly rate)

Example (2). B, a factory employee of the same employer, is paid regular wages on the basis of a 10-day pay period. B's regular wages are $200 per pay period. If B is absent from work for 15 days, the weekly rate of the amount he receives under his employer's plan will be determined as follows:

365 × $200 ÷ 10	$7,300 (annual rate)
$7,300 ÷ 52	$140.38 (weekly rate)

(iii) If the weekly rate for purposes of section 105(d) (as determined in subdivision (ii) of this subparagraph) does not exceed $100, the amount received which is not attributable to the 7-day waiting period described in paragraph (c) of this section is fully excludable from gross income. If the weekly rate for purposes of section 105(d) (as determined in subdivision (ii) of this subparagraph) exceeds $100, the amount received which is not attributable to the 7-day waiting period provided in paragraph (c) of this section is only partially excludable. The excludable portion of such amount shall bear the same ratio to such amount as $100 bears to the weekly rate for purposes of section 105(d). This rule may be illustrated by the following example:

Example. The weekly rate of benefits in the case of employee A in example (1) of subdivision (ii) of this subparagraph was $120. If A does not receive amounts under any other plan, this is the weekly rate for purposes of section 105(d). Assume that A is absent from work on account of a personal injury for one full month and receives full pay of $520 for such period of absence. Since there is no waiting period requirement, the exclusion is $433.33 computed as follows:

$$\$100 - \$120 \times \$520 \text{ or } \$433.33.$$

(g) *Limitation in the case of absence from work on account of personal injury or sickness for periods commencing after December 31, 1963.* (1) In the case of periods of absence from work on account of sickness or personal injury commencing after December 31, 1963, the exclusion provided by section 105(d) does not apply to amounts attributable to the first 30 calendar days of each such period, if such amounts are at a rate which exceeds 75 percent of the employee's "regular weekly rate of wages", as determined under subparagraph (5) of this paragraph. If the amounts are at a rate of 75 percent or less of the employee's "regular weekly rate of wages", the exclusion provided by section 105(d) does not apply to amounts attributable to the first 7 calendar days of each such period, unless the employee is hospitalized on account of personal injury or sickness for at least one day during the period of absence from work. The 7- or 30-day waiting period (whichever is applicable) applies to each period of absence from work because of personal injury or sickness, regardless of the frequency of such absences or the closeness in time to any prior period of absence from work because of personal injury or sickness. The waiting period is to be counted by beginning with the first work day for which the employee was absent. These rules may be illustrated by the following examples:

Example (1). Employee A is absent from work because of sickness on Tuesday, January 7, 1964, and returns to work on the morning of Thursday, February 13, 1964. He

suffers a relapse and again becomes absent from work on the afternoon of Thursday, February 13, 1964. A's return to work on the morning of Thursday, February 13, 1964, terminates the first period of absence from work because of sickness, and a new period of absence from work because of sickness begins on the afternoon of Thursday, February 13, 1964.

Example (2). Employee B normally works five days (Monday through Friday) during each week. On Saturday, January 11, 1964 (a nonworking day), B becomes sick or injured and as a result he does not return to work until Monday, February 17, 1964. The period of absence from work commences on Monday, January 13, 1964, and terminates when B returns to work on Monday, February 17, 1964. Assuming B receives amounts under his employer's wage continuation plan at a rate exceeding 75 percent of his "regular weekly rate of wages" (as determined under subparagraph (5) of this paragraph), the exclusion provided by section 105(d) does not apply to amounts B receives under his employer's wage continuation plan which are attributable to the 30-day period commencing Monday, January 13, 1964, and ending Tuesday, February 11, 1964, inclusive. If B receives amounts under his employer's wage continuation plan at a rate which is 75 percent or less of his "regular weekly rate of wages" and he is not hospitalized during the period of absence from work, the exclusion provided by section 105(d) does not apply to amounts B receives which are attributable to the 7-day period commencing Monday, January 13, 1964, and ending Sunday, January 19, 1964, inclusive.

Example (3). Employee C is sick or incurs a personal injury which causes him to be absent from work for two weeks. He receives amounts under his employer's wage continuation plan at a rate which is 75 percent or less of his "regular weekly rate of wages" (as determined under subparagraph (5) of this paragraph) and is hospitalized from the eighth through the eleventh day of his absence. Since C was hospitalized on account of personal injury or sickness for at least one day during the period of absence, the 7-day waiting period does not apply, and, subject to the other requirements of section 105(d), C is entitled to an exclusion with respect to the amounts received under his employer's plan attributable to the two- week period of absence. If C were receiving amounts under his employer's wage continuation plan at a rate exceeding 75 percent of his "regular weekly rate of wages", he would not be entitled to an exclusion under section 105(d).

(2) For the purpose of starting the 7- or 30-day waiting period, whichever is applicable, if the period of absence commences after the start of a working day, the amount received with respect to the portion of such day that the employee is absent from work shall be considered an amount attributable to the first calendar day of the period of absence from work. This rule may be illustrated by the following example:

Example. Employee D normally works from 9 a.m. until 5:30 p.m. on five days (Monday through Friday) during each week. From noon on Wednesday, January 8, 1964, until noon on Monday, February 17, 1964, D is absent from work on account of personal injury or sickness but is not hospitalized at any time during this period. D receives amounts under his employer's wage continuation plan at a rate not exceeding 75 percent of his "regular weekly rate of wages" (as determined under subparagraph (5) of this paragraph). Section 105(d) does not apply to amounts received by D under his employer's wage continuation plan which are attributable to the calendar period beginning January 8, 1964, and continuing through January 14, 1964, inclusive. However, if the other requirements of section 105(d) are met, D may exclude from gross income amounts attributable to the remainder of the period of absence, ending at noon on Monday, February 17, 1964.

(3) If the exclusion is subject to a 7- or 30-calendar-day waiting period, any amount attributable to such 7- or 30-calendar-day waiting period includes all amounts paid therefor, regardless of the number of work days included in such 7 or 30 calendar days. For example, if on one of the days included in the waiting period, an employee would have worked two 8-hour shifts, the amount he is paid for the two shifts is considered to be attributable to only one calendar day.

(4) An employee is considered to be hospitalized for one day only if he is admitted to and confined in a hospital as a bed patient for at least one hospital day. Entry into a hospital as an in and-out-patient does not constitute hospitalization for purposes of section 105(d). The same applies to mere entry into the out-patient ward or the emergency ward of a hospital.

(5) (i) In general, the "regular weekly rate of wages", for purposes of section 105(d), shall be the average weekly wages paid for the last four weekly periods falling within a full pay period or full pay periods immedi-

ately preceding the commencement of the period of absence. If the employee was absent from work for three or more normal working days during any such pay period, and the amount of wages paid for such pay period was less than the amount of wages paid for the immediately preceding pay period during which the employee was not absent from work for three or more normal working days, then the amount of wages paid for the weekly period or weekly periods falling wholly or partly within the pay period during which each such absence occurred shall not be used in the determination of "regular weekly rate of wages". In such a case, there shall be substituted the amount of wages paid for the last weekly period or weekly periods falling within the pay period or pay periods immediately preceding the pay period or pay periods in which such absence or absences occurred during which the employee was not absent from work for three or more normal working days.

(*a*) In order to compute wages paid for the last four weekly periods falling within a full pay period or full pay periods immediately preceding the commencement of the period of absence, or any substituted weekly periods therefor, it will be necessary to convert the wages paid for any pay period other than a weekly pay period into a weekly rate or weekly rates of payment of such wages in accordance with the rules stated in subdivision (iv) of this subparagraph. Such weekly rate or weekly rates of wage payments are then used in determining the wages for the last four weekly periods falling within a full pay period or full pay periods immediately preceding the commencement of the period of absence, or any substituted weekly periods therefor.

(*b*) If the employee does not have four weekly periods falling within a full pay period or full pay periods preceding his absence during which he was not absent from work for three or more normal working days, then the greatest number of available weekly periods shall be used, consistent with the rules set forth in this subdivision (i), in determining the "regular weekly rate of wages."

(*c*) If the employee has been employed for a full pay period or more preceding his absence, and has worked for the number of days in a normal work week, but was absent from work for three or more normal working days during each of the pay periods preceding his absence, then the "regular weekly rate of wages" shall be determined by multiplying the employee's actual wages paid for the total number of normal working days in the pay period immediately preceding the employee's absence by the number of days that the employee is expected to work in a normal work week, and by dividing the product by the number of normal work days in such pay period for which wages were paid.

(*d*) If the employee has not been employed for a full pay period preceding his absence, and has worked for the number of days in a normal work week, the "regular weekly rate of wages" shall be determined by multiplying the employee's actual wages paid for the total number of normal working days preceding the employee's absence by the number of days that the employee is expected to work in a normal work week, and by dividing the product by the number of normal work days for which wages were paid.

(*e*) If the employee has not worked the number of days in a normal work week, then there is no "regular weekly rate of wages," and the employee will not be permitted an exclusion under section 105(d) for amounts attributable to the first 30 calendar days in the period of absence.

(*f*) Wages paid by a former employer shall not be used in the determination of "regular weekly rate of wages" as described in this subparagraph.

(ii) In the case of a wage continuation plan of an employer under which the benefits are computed as a specified percentage of average wages, the formula for computing the employee's average wages included in the plan may be used (in lieu of the formula provided in subdivision (i) of this subparagraph) for determining the "regular weekly rate of wages" for purposes of section 105(d), if under the plan—

(*a*) The definition of wages does not include any items which are not considered "wages" as defined in subdivision (iii) of this subparagraph,

(*b*) The period for computing average wages is not less than twenty-eight successive calendar days, does not end earlier than five months preceding the date on which the period of absence commences, and is one in which the employee was at work at least 35 percent of the normal working time, and

(*c*) The period and formula for computing average wages are applied uniformly with respect to all employees eligible to receive benefits under the plan. A plan will not fail to meet the conditions of this subdivision merely because different portions of the employee's wages are averaged over different periods for purposes of computing his average wages, so long as each such period meets the requirements in (*b*) and (*c*) of this subdivision.

(iii) For the purpose of determining "regular weekly rate of wages" under subdivision (i) or (ii) of this subparagraph, whichever is applicable, an employee's wages shall comprise basic salary, fees, commissions, tips, gratuities, overtime, and any other type of taxable compensation which is normally paid for services. However, wages shall not include any type of compensation which is not normally paid, such as bonuses and incentive payments. An employee's compensation, for the purpose of determining his "regular weekly rate of wages", will not include any compensation which is not currently includible in gross income. For example, an employee's wages for the purpose of this subdivision shall not include deferred compensation paid by the employer which is not includible in gross income until received by the employee, such as employer contributions to a qualified annuity under section 403(a), or employer contributions to an accident or health plan excluded under section 106.

(iv) The following rules shall be used to convert wages for pay periods other than weekly pay periods into weekly rates of wage payments to be used in determining "regular weekly rate of wages" as described in subdivision (i) of this subparagraph.

(*a*) If wages are paid biweekly, the weekly rate of wage payments shall be one-half of the biweekly wages paid.

(*b*) If the employee is paid semimonthly, the weekly rate of wage payments shall be the semimonthly wages paid multiplied by 24 and divided by 52.

(*c*) If wages are paid monthly, the weekly rate of wage payments shall be the monthly wages paid multiplied by 12 and divided by 52.

(*d*) If wages are paid on the basis of a pay period other than a period described in (*a*) through (*c*) of this subdivision, the weekly rate of wage payments shall be determined by ascertaining the annual rate of wage payments and dividing by 52.

(*e*) For the purpose of this subparagraph, if separate portions of an employee's wages are paid on the basis of different pay periods, the weekly rate or weekly rates of wage payments of each portion of wages paid with respect to each pay period shall first be determined under the rules set forth in (*a*) through (*d*) of this subdivision and the average weekly rate of each portion of wages, determined in accordance with the rules set forth in subdivision (*i*) of this subparagraph, shall be aggregated to determine the employee's "regular weekly rate of wages" for purposes of section 105(d).

(v) The provisions of subdivisions (i), (iii) and (iv) of this subparagraph may be illustrated by the following examples:

Example (1). Employee A is a salesman who is paid a basic salary of $60 per week and, in addition, is paid commissions on a weekly basis. A became ill and did not report for work beginning Monday, February 17, 1964. For the four-week period preceding the commencement of the period of absence, A was paid the following:

Week of—	Basic salary	Commissions	Total weekly wages
Jan. 20, 1964	$60	$10	$70
Jan. 27, 1964	60	50	110
Feb. 3, 1964	60	30	90
Feb. 10, 1964	60	40	100
Total 4-week wages			370

A's wages, under the rules set forth in subdivision (iii) of this subparagraph, consist of basic salary plus commissions. Since the amount of A's average weekly wages paid for the last four weekly periods falling within the four pay periods immediately preceding the commencement of his period of absence from work is $92.50 ($370÷4), such amount is considered as the "regular weekly rate of wages" (as computed under subdivision (i) of this subparagraph) for purposes of section 105(d).

Example (2). Assume, in example (1), that A normally works five days during each week (Monday through Friday) and that he was also absent from work for any reason from Monday, February 3, 1964, through Wednesday, February 5, 1964. Since A was absent from work for three normal working days during the pay period of February 3, 1964, and was paid a lesser amount of wages for such pay period than in the immediately preceding pay period during which he was not absent from work (week of January 27), the weekly pay period beginning January 27, 1964 is substituted for the weekly pay period beginning February 3, 1964 in the determination of "regular weekly rate of wages" (as computed under subdivision (i) of this subparagraph) for purposes of section 105(d). The "regular weekly rate of wages" is calculated to be $97.50, as follows:

Week of	Total wages
February 10	$100
January 27 (substitute for week of Feb. 3)	110
January 27	110
January 20	70

390÷4=$97.50

Example (3). Employee B is a salesman who is paid a basic salary of $75 and, in addition, is paid commissions for semi-monthly periods ending on the 15th day and the last day of each month. He was absent from work on account of a personal injury beginning Monday, February 17, 1964. He was paid the following amounts:

Pay period	Salary	Commissions	Total wages
Feb. 1–15, 1964	$75	$60	$135
Jan. 16–31, 1964	75	50	125

The four weekly periods falling within full pay periods preceding the commencement of the period of absence are the weeks beginning February 9, February 2, January 26, and January 19. B's wages are converted to weekly rates of wage payments per pay period in accordance with the rule set forth in subdivision (iv)(*b*) of this subparagraph as follows:

From February 1, 1964–February 15, 1964, inclusive:

$135×24=$3240.00 (annual rate)

$$\frac{\$3240.00}{52}=\$62.31 \text{ (weekly rate)}$$

From January 16–31, inclusive:

$125×24=$3000.00 (annual rate)

$$\frac{\$3000.00}{52}=\$57.69 \text{ (weekly rate)}$$

The weekly rates are then used in determining the wages for four weekly periods falling within the pay periods immediately preceding the commencement of B's absence. B's "regular weekly rate of wages" (as computed under subdivision (i) of this subparagraph) is calculated to be $60.17, as follows:

Feb. 9–15, inclusive	$62.31
February 2–8, inclusive	62.31
January 26–February 1, inclusive (⅘×$57.69+⅕×$62.31)	58.35
January 19–25, inclusive	57.69
	240.66÷4=$60.17

Example (4). Employee C is paid semi-monthly on the 5th and 20th of each month and he began working for his present employer at the beginning of the semi-monthly pay period commencing Tuesday, January 21, 1964. C received total wages of $200 for the pay period of January 21, 1964 through February 5, 1964, inclusive. He was not absent during that pay period. C became sick and was absent from work beginning February 7, 1964. Since employee C does not have four weekly periods falling within a full pay period or full pay periods preceding his absence, the average wages for the last two weekly periods falling within such full pay period will be C's "regular weekly rate of wages" (as computed under subdivision (i) of this subparagraph) for purposes of section 105(d), determined to be $92.31, as follows:

$200×24=$4800 (annual rate)
$4800÷52=$92.31 (weekly rate)

Example (5). Employee D, an office worker, is paid weekly and is expected to work five days during each week. He has been employed by his present employer for three weeks, but has been absent from work for three normal work days in each of the weeks preceding his illness. He became ill and was absent from work on Monday, February 17, 1964. During the weekly pay period immediately preceding his absence (week of February 10) D was paid $48 salary. He was paid for two working days

during such weekly pay period. D's "regular weekly rate of wages" (as computed under subdivision (i) of this subparagraph), is calculated to be $120.00, determined as follows:

$$\frac{\$48 \text{ (total wages)} \times 5 \text{ (normal work days in week)}}{2 \text{ (number of work days for which wages were paid)}} = \$120.00$$

Example (6). Employee E is an hourly worker who is paid a salary of $1.25 per hour. E is paid basic salary on a biweekly basis for the periods beginning every other Thursday and ending every other Wednesday. E is also paid monthly for his overtime work and is compensated for such work at one and one-half times the hourly rate. E worked 16 hours of overtime for his employer during the month of January. E was injured and could not report for work on Friday, February 21, 1964. E returned to work on Monday, March 16, 1964. E was paid as follows for the pay periods indicated:

Pay period	Hours		Salary per hour		Total salary
	Regular	Overtime	Regular	Overtime	
Month of January 1964		16		$1.875	$30
Jan. 23–Feb. 5, 1964, inclusive	80		$1.25		100
Feb. 6–19, 1964, inclusive	80		1.25		100

Under the rule set forth in subdivision (iv)(*e*) of this subparagraph, the weekly rates of payment of salary and overtime must be determined separately. Since basic salary is paid biweekly, the weekly rate of payment is determined to be one-half of $100.00, or $50.00. The full pay period immediately preceding the commencement of E's absence for overtime compensation ended on January 31, 1964. E's overtime earnings are converted to a weekly rate for such period, as follows:

$30.00 (overtime pay) × 12 = $360.00 (annual rate)
$360.00 ÷ 52 = $6.93 (weekly rate)

The average wages for the last four weekly periods falling within pay periods immediately preceding the commencement of E's absence with respect to basic salary (weeks of February 13, 6, January 30, and 23) is $50.00. The average wages for the last four weekly periods falling within the pay period immediately preceding the commencement of E's absence with respect to overtime compensation (weeks of January 25, 18, 11, and 4) is $6.93. Accordingly, E's "regular weekly rate of wages" (as computed under subdivision (i) of this subparagraph) for the purpose of section 105(d) is $56.93.

(6) (i) Amounts paid under a wage continuation plan must be converted to a weekly rate in order to determine the percentage of benefits paid in relation to the employee's "regular weekly rate of wages", since such percentage is used in determining the waiting period, if any, after which an exclusion is allowable under section 105(d). In order to calculate the weekly rate at which benefits are being paid, reference is made to the particular wage continuation plan. If, in the usual operation of the plan, benefits are paid for the same periods as regular wages, then the pay period of such benefits shall be the period for which a payment of wages is ordinarily made to the employee by the employer. If plan benefits are ordinarily paid for different periods than regular wages, then the pay period of such benefits shall be the period for which payment of such benefits is ordinarily made.

(ii) The weekly rate at which the benefits are paid under a wage continuation plan shall be determined in accordance with the following rules:

(*a*) If benefits are paid on the basis of a weekly pay period, the weekly rate at which such benefits are paid shall be the weekly amount of such benefits.

(*b*) If benefits are paid on the basis of a biweekly pay period, the weekly rate at which such benefits are paid shall be one-half of the biweekly rate.

(*c*) If benefits are paid on the basis of a semimonthly pay period, the weekly rate at which such benefits are paid shall be the semimonthly rate multiplied by 24 and divided by 52.

(*d*) If benefits are paid on the basis of a monthly pay period, the weekly rate at which such benefits are paid shall be the monthly rate multiplied by 12 and divided by 52.

(*e*) If benefits are paid on the basis of a period other than a period de-

scribed in (*a*) through (*d*) of this subdivision the weekly rate at which such benefits are paid shall be determined by ascertaining the annual rate at which such benefits are paid and dividing such annual rate by 52.

(iii) The principles of subdivisions (i) and (ii) of this subparagraph may be illustrated by the following example:

Example. A's employer maintains a noncontributory plan which provides for a monthly benefit of $400 during periods of absence from work due to personal injury or sickness. A, a salesman, receives regular salary of $520 per calendar month plus commissions, depending upon the amount of sales made by A during the month. During the month of January 1964, A was paid commissions of $180. A received a total benefit of $200 for an absence of two weeks because of illness occurring in February 1964. He was not hospitalized. Since benefits under the salary continuation plan are paid for the same period as regular wages, the pay period of the plan is monthly. A's "regular weekly rate of wages", determined in accordance with the rules set forth in subparagraph (5)(i) of this paragraph is $161.54. ($700×12)÷52.

For purposes of determining the percentage of benefits paid in relation to A's "regular weekly rate of wages", the weekly rate of the benefits are calculated to be $92.31, as follows:

$400 (monthly rate)×12=$4,800 (annual rate)
$4,800÷52=$92.31 (weekly rate)

Since $92.31 does not exceed 75 percent of A's "regular weekly rate of wages", A is entitled to an exclusion under section 105(d) for the second week of absence, subject to the other limitations provided in this section.

(iv) For the purpose of determining whether or not the rate of benefits paid under a wage continuation plan for a period of absence exceeds 75 percent of the employee's "regular weekly rate of wages" (as determined under subparagraph (5) of this paragraph), it is necessary to ascertain the average percentage of benefits paid in relation to the employee's "regular weekly rate of wages" for the first 30 calendar days in the period of absence. Such percentage is derived from a fraction, the numerator of which is the sum of benefits paid (attributable to employer contributions) for the period of absence occurring within the first 30 calendar days, and the denominator of which is the collective sum of the employee's "regular weekly rate of wages" during such period. This rule may be illustrated by the following examples:

Example (1). Employee A is paid a semimonthly basic salary of $150 plus commissions. He normally works five days during each week (Monday through Friday). During the month of January 1964, A received wages of $150 plus commissions of $66.67 for each of the semimonthly pay periods. A became ill on Monday, February 3, 1964, and as a result was absent from work until Monday, February 17, 1964, but was not hospitalized. Under the noncontributory wage continuation plan of A's employer, A received no benefits for the first three working days' absence (Monday through Wednesday) and was paid benefits at the rate of $100 a week thereafter. A's "regular weekly rate of wages," determined under the rules set forth in subparagraph (5) of this paragraph, is $100. A is considered to have received average benefits at a rate of 70 percent of his "regular weekly rate of wages", computed as follows:

(1)	(2)	(3)
Week of absence	Benefits paid	Regular weekly rate of wages
1-Feb. 3	$40	$100
2-Feb. 10	100	100
Total	140	200

Average percentage of benefits paid— 140/200 =70%. Accordingly, A may exclude amounts attributable to the second week of absence, subject to the other limitations of section 105(d).

Example (2). Assume, in example (1), that A did not return to work until Thursday, February 20, 1964. A is considered to have received average benefits at the rate of 76.92 percent of his "regular weekly rate of wages", computed as follows:

(1)	(2)	(3)
Week of absence	Benefits paid	Regular weekly rate of wages
1-Feb. 3	$40	$100
2-Feb. 10	100	100
2⅗—Feb. 17	[1] 60	[1] 60
Total	200	260

[1] Three-fifths of 100.

Average percentage of benefits paid— 200/260=76.92%. Accordingly, A would not be

permitted any exclusion under section 105(d).

(v) If with respect to any pay period or portion thereof the employee receives amounts under two or more wage continuation plans (whether such plans are maintained by or for the same employers or by different employers), the weekly rate for purposes of section 105(d) shall be the sum of the weekly rates received under all plans. This rule may be illustrated by the following example:

Example. An employee who is absent because of personal injuries or sickness receives $100 biweekly under wage continuation plan A maintained by his employer. He contributes one-half of the premiums for maintenance of the plan. Under wage continuation plan B maintained by his employer the employee receives $400 monthly. Plan B is noncontributory. The weekly rate at which benefits are paid for the purpose of section 105(d) is computed as follows:

Plan A—	$\frac{\$100}{2}$	=$50.00	(weekly rate)
		25.00	(less amount attributable to employee contributions (½))
		25.00	(weekly rate of Plan A)
Plan B—	$\frac{\$400 \times 12}{52}$	=92.31	(weekly rate of Plan B)
		$117.31	(combined weekly rate at which benefits are paid)

The $25 attributable to contributions made by the employee under Plan A would be subject to section 104(a)(3).

(f) *Amount of exclusion for periods of absence commencing after December 31, 1963*—(1) *In general.* Amounts received under a wage continuation plan attributable to periods of absence commencing after December 31, 1963, and which are not excludable from gross income as being attributable to contributions of the employee (see § 1.105-1) are excludable from gross income of the employee to the extent that such amounts do not exceed—

(i) A weekly rate of $75, during the first 30 calendar days in the period of absence; and

(ii) A weekly rate of $100, after the first 30 calendar days in the period of absence.

For example, an employee who normally works five days during each week is absent from work for two days, is hospitalized during his absence, and receives $75 under his employer's wage continuation plan, which amount is at a rate of 75 percent of his "regular weekly rate of wages". The employee cannot exclude the entire $75 under section 105(d), if the weekly rate of such benefits exceeds $75.

(2) *Daily exclusion.* An employee receiving payments under a wage continuation plan must, in order to determine the amount of the exclusion under section 105(d), compute the daily rate of the benefits. Such daily rate is determined, for amounts attributable to the first 30 calendar days in the period of absence, by dividing the weekly rate at which benefits are paid (as determined under paragraph (e)(6)(ii) of this section), or the maximum weekly rate at which wage continuation payments are excludable ($75), whichever is lower, by the number of work days in a normal work week. In the case of amounts attributable to days in a period of absence after the first 30 calendar days, the daily rate for such period is determined by dividing the weekly rate at which benefits are paid (as determined under paragraph (e)(6)(ii) of this section), or the maximum weekly rate at which wage continuation payments are excludable ($100), whichever is lower, by the number of work days in a normal work week. The daily rate or daily rates of exclusion are then multiplied by the number of normal work days in the period of absence for which an exclusion is allowable in order to determine the total allowable exclusion. These rules may be illustrated by the following examples:

Example (1). Employee A is a salesman receiving salary and commissions on a weekly basis. His employer maintains a noncontributory wage continuation plan which provides for the continuation of A's basic salary of $80 per week during periods of absence. A was absent from work on account of sickness from Monday, February 3, 1964, through Sunday, March 15, 1964, but was not hospitalized. His normal work week is from Monday through Friday. The weekly amount of benefits paid to A ($80) does not exceed 75 percent of his "regular weekly rate of wages" as defined in paragraph (e)(5) of this section. Under section 105(d), the daily rate of exclusion for amounts attributable to the first 30 calendar days in

the period of absence, excluding the first 7 days thereof (Monday, February 10, 1964, through Tuesday, March 3, 1964, inclusive) is limited to $15 ($75, maximum weekly rate of exclusion divided by 5 (number of normal work days in week)). The daily rate of exclusion for amounts attributable to the period of absence in excess of 30 calendar days (Wednesday, March 4, 1964, through Sunday, March 15, 1964, inclusive) is limited to $16 ($80, weekly rate of benefits divided by 5). Thus, the total exclusion permitted to employee A by section 105(d) is $383.00 ($15 × 17 work days ($255) + $16 × 8 work days ($128)).

Example (2). Assume the facts in example (1) except that A is paid benefits at the rate of $500 a month during periods of absence. The weekly rate of the benefits computed under the rules stated in paragraph (e)(6)(ii) of this section is $115.38, which amount does not exceed 75 percent of his "regular weekly rate of wages" as defined in paragraph (e)(5) of this section. Under section 105(d), the daily rate of exclusion for amounts attributable to the first 30 calendar days in the period of absence, excluding the first 7 days thereof (Monday, February 10, 1964, through Tuesday, March 3, 1964, inclusive) is limited to $15 ($75, maximum weekly rate of exclusion divided by 5). The daily rate of exclusion for amounts attributable to the period of absence in excess of 30 calendar days (Wednesday, March 4, 1964, through Sunday, March 15, 1964, inclusive) is limited to $20 ($100, maximum weekly rate of exclusion divided by 5). Thus, the total exclusion permitted to employee A by section 105(d) is $415.00 ($15 × 17 work days ($255) + $20 × 8 work days ($160)).

Example (3). Employee B, an office worker works five days during each week (Monday through Friday) and receives a salary of $85 per week. His employer maintains a noncontributory wage continuation plan which provides for no benefits during the first three days of absence, the continuation of full salary for one week thereafter and benefits at the rate of $65 per week thereafter. B was absent from work on account of sickness from Monday, March 16, 1964, through Tuesday, March 31, 1964, and was hospitalized from Wednesday, March 18, through Tuesday, March 24. B received total benefits of $137 for the period of absence, which does not exceed 75 percent of his "regular weekly rate of wages" as determined under paragraph (e)(5) of this section. B is permitted an exclusion under section 105(d) of $127 calculated as follows:

Period of absence	Weekly rate of benefits	Maximum weekly rate of exclusion	Daily rate of exclusion	Days of absence in period	Maximum exclusion
Mar. 16–18	0	$75	0	3	0
Mar. 19–25	$85	75	$15	5	$75
Mar. 26–31	65	75	13	4	52
Total exclusion					$127

(g) *Definitions.* The term "personal injury" as used in this section, means an externally caused sudden hurt or damage to the body brought about by an identifiable event. The term "sickness" as used in this section, means mental illnesses and all bodily infirmities and disorders other than "personal injuries". Diseases, whether resulting from the occupation or otherwise, are not considered personal injuries, but they are treated as a sickness.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6770, 29 FR 15366, Nov. 17, 1964; T.D. 7352, 40 FR 16666, Apr. 14, 1975]

§ 1.105-5 Accident and health plans.

(a) *In general.* Sections 104(a)(3) and 105 (b), (c), and (d) exclude from gross income certain amounts received through accident or health insurance. Section 105(e) provides that for purposes of sections 104 and 105 amounts received through an accident or health plan for employees, and amounts received from a sickness and disability fund for employees maintained under the law of a State, a Territory, or the District of Columbia, shall be treated as amounts received through accident or health insurance. In general, an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness. A plan may cover one or more employees, and there may be different plans for different employees or classes of employees. An accident or health plan may be either insured or noninsured, and it is not necessary that the plan be in writing or that the employee's rights to benefits

under the plan be enforceable. However, if the employee's rights are not enforceable, an amount will be deemed to be received under a plan only if, on the date the employee became sick or injured, the employee was covered by a plan (or a program, policy, or custom having the effect of a plan) providing for the payment of amounts to the employee in the event of personal injuries or sickness, and notice or knowledge of such plan was reasonably available to the employee. It is immaterial who makes payment of the benefits provided by the plan. For example, payment may be made by the employer, a welfare fund, a State sickness or disability benefits fund, an association of employers or employees, or by an insurance company.

(b) *Self-employed individuals.* Under section 105(g), a self-employed individual is not treated as an employee for purposes of section 105. Therefore, for example, benefits paid under an accident or health plan as referred to in section 105(e) to or on behalf of an individual who is self-employed in the business with respect to which the plan is established will not be treated as received through accident and health insurance for purposes of sections 104(a)(3) and 105.

[T.D. 6722, 29 FR 5071, Apr. 14, 1964]

§ 1.105-6 Special rules for employees retired before January 27, 1975.

(a) *Application of section 105(d) to amounts received as retirement annuities.* An employee who retired from work before January 27, 1975, receiving payments under his employer-established plan (to which § 1.72-15(a) applies) which payments were not treated as amounts received under a wage continuation plan for purposes of section 105(d), may, as of the date the employee retired, treat such plan as such a wage continuation plan to the extent such payments are received prior to mandatory retirement age (as described in § 1.105-4(a)(3)(i)(B)), if—

(1) His employer had in operation at the time of his retirement a program providing accident and health benefits under a wage continuation plan to which section 105(d) would apply;

(2) The employer certifies, under procedures approved in advance under paragraph (c) of this section, that the employee would have been eligible for wage continuation benefits, under the terms and conditions of his employer's plan, because of personal injuries or sickness;

(3) At the time of the employee's retirement there was no substantive difference between the benefits being actually received and the benefits he would have received had he retired under his employer's wage continuation plan; and

(4) The employee agrees to the adjustments and conditions required by the Commissioner with respect to amounts excluded under section 72 (b) or (d) in taxable years ending before January 27, 1975.

(b) *Filing requirements.* (1) The certification required in paragraph (a)(2) and the agreement required in paragraph (a)(4) of this section shall be filed on or before April 15, 1977, with the return, or timely amended return or claim, made for the taxable year in which the employee reached retirement age as described in § 1.79-2(b)(3), or, for the first taxable year for which the taxpayer files an income tax return claiming an exclusion under section 105(d), as provided in paragraph (a) of this section.

(2) The Commissioner may prescribe a form and instructions with respect to the agreement provided for in paragraph (a)(4) of this section.

(c) *Employer certification*—(1) *Advance approval of procedures.* Any reasonable and consistently applied procedures, approved in advance by the Internal Revenue Service, which require the employee to provide the employer or the insurer with medical documentation sufficient to show that an illness or disability existed as of the date of the employee's retirement, which would have entitled him to retire on account of personal injuries or sickness alone, are sufficient for purposes of this paragraph.

(2) *Place of submission.* Request for advance approval of procedures for certification shall be submitted to the district director.

(d) *Cross reference.* For special rules pertaining to taxpayers retired on disability before January 27, 1975, see § 1.72-15(i).

[T.D. 7352, 40 FR 16666, Apr. 14, 1975]

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§ 1.105-11 Self-insured medical reimbursement plan.

(a) *In general.* Under section 105(a), amounts received by an employee through a self-insured medical reimbursement plan which are attributable to contributions of the employer, or are paid by the employer, are included in the employee's gross income unless such amounts are excludable under section 105(b). For amounts reimbursed to a highly compensated individual to be fully excludable from such individual's gross income under section 105(b), the plan must satisfy the requirements of section 105(h) and this section. Section 105(h) is not satisfied if the plan discriminates in favor of highly compensated individuals as to eligibility to participate or benefits. All or a portion of the reimbursements or payments on behalf of such individuals under a discriminatory plan are not excludable from gross income under section 105(b). However, benefits paid to participants who are not highly compensated individuals may be excluded from gross income if the requirements of section 105(b) are satisfied, even if the plan is discriminatory.

(b) *Self-insured medical reimbursement plan*—(1) *General rule*—(i) *Definition.* A self-insured medical reimbursement plan is a separate written plan for the benefit of employees which provides for reimbursement of employee medical expenses referred to in section 105(b). A plan or arrangement is self-insured unless reimbursement is provided under an individual or group policy of accident or health insurance issued by a licensed insurance company or under an arrangement in the nature of a prepaid health care plan that is regulated under federal or state law in a manner similar to the regulation of insurance companies. Thus, for example, a plan of a health maintenance organization, established under the Health Maintenance Organization Act of 1973, would qualify as a prepaid health care plan. In addition, this section applies to a self-insured medical reimbursement plan, determined in accordance with the rules of this section, maintained by an employee organization described in section 501(c)(9).

(ii) *Shifting of risk.* A plan underwritten by a policy of insurance or a prepaid health care plan that does not involve the shifting of risk to an unrelated third party is considered self-insured for purposes of this section. Accordingly, a cost-plus policy or a policy which in effect merely provides administrative or bookkeeping services is considered self-insured for purposes of this section. However, a plan is not considered self-insured merely because one factor the insurer uses in determining the premium is the employer's prior claims experience.

(iii) *Captive insurance company.* A plan underwritten by a policy of insurance issued by a captive insurance company is not considered self-insured for purposes of this section if for the plan year the premiums paid by companies unrelated to the captive insurance company equal or exceed 50 percent of the total premiums received and the policy of insurance is similar to policies sold to such unrelated companies.

(2) *Other rules.* The rules of this section apply to a self-insured portion of an employer's medical plan or arrangement even if the plan is in part underwritten by insurance. For example, if an employer's medical plan reimburses employees for benefits not covered under the insured portion of an overall plan, or for deductible amounts under the insured portions, such reimbursement is subject to the rules of this section. However, a plan which reimburses employees for premiums paid under an insured plan is not subject to this section. In addition, medical expense reimbursements not described in the plan are not paid pursuant to a plan for the benefit of employees, and therefore are not excludable from gross income under section 105(b). Such reimbursements will not affect the determination of whether or not a plan is discriminatory.

(c) *Prohibited discrimination*—(1) *In general.* A self-insured medical reimbursement plan does not satisfy the requirements of section 105(h) and this paragraph for a plan year unless the plan satisfies subparagraphs (2) and (3) of this paragraph. However, a

plan does not fail to satisfy the requirements of this paragraph merely because benefits under the plan are offset by benefits paid under a self-insured or insured plan of the employer or another employer, or by benefits paid under Medicare or other Federal or State law or similar foreign law. A self-insured plan may take into account the benefits provided under another plan only to the extent that the type of benefit subject to reimbursement is the same under both plans. For example, an amount reimbursed to an employee for a hospital expense under a medical plan maintained by the employer of the employee's spouse may be offset against the self-insured benefit where the self-insured plan covering the employee provides the same type of hospital benefit.

(2) *Eligibility to participate*—(i) *Percentage test.* A plan satisfies the requirements of this subparagraph if it benefits—

(A) Seventy percent or more of all employees, or

(B) Eighty percent or more of all the employees who are eligible to benefit under the plan if 70 percent or more of all employees are eligible to benefit under the plan.

(ii) *Classification test.* A plan satisfies the requirements of this subparagraph if it benefits such employees as qualify under a classification of employees set up by the employer which is found by the Internal Revenue Service not to be discriminatory in favor of highly compensated individuals. In general, this determination will be made based upon the facts and circumstances of each case, applying the same standards as are applied under section 410(b)(1)(B) (relating to qualified pension, profit-sharing and stock bonus plans), without regard to the special rules in section 401(a)(5) concerning eligibility to participate.

(iii) *Exclusion of certain employees.* Under section 105(h)(3), for purposes of this subparagraph (2), there may be excluded from consideration:

(A) Employees who have not completed 3 years of service prior to the beginning of the plan year. For purposes of this section years of service may be determined by any method that is reasonable and consistent. A determination made in the same manner as (and not requiring service in excess of how) a year of service is determined under section 410(a)(3) shall be deemed to be reasonable. For purposes of the 3-year rule, all of an employee's years of service with the employer prior to a separation from service are not taken into account. For purposes of the 3-year rule, an employee's years of service prior to age 25, as a part-time or seasonal employee, as a member of a collective bargaining unit, or as a nonresident alien, as each is described in this subdivision, are not excluded by reason of being so described from counting towards satisfaction of the rule. In addition, if the employer is a predecessor employer (determined in a manner consistent with section 414(a)), service for such predecessor is treated as service for the employer.

(B) Employees who have not attained age 25 prior to the beginning of the plan year.

(C) Part-time employees whose customary weekly employment is less than 35 hours, if other employees in similar work with the same employer (or, if no employees of the employer are in similar work, in similar work in the same industry and location) have substantially more hours, and seasonal employees whose customary annual employment is less than 9 months, if other employees in similar work with the same employer (or, if no employees of the employer are in similar work, in similar work in the same industry and location) have substantially more months. Notwithstanding the preceding sentence, any employee whose customary weekly employment is less than 25 hours or any employee whose customary annual employment is less than 7 months may be considered as a part-time or seasonal employee.

(D) Employees who are included in a unit of employees covered by an agreement between employee representatives and one or more employers which the Commissioner finds to be a collective bargaining agreement, if accident and health benefits were the subject of good faith bargaining between such employee representatives and such employer or employers. For

purposes of determining whether such bargaining occurred, it is not material that such employees are not covered by another medical plan or that the plan was not considered in such bargaining.

(E) Employees who are nonresident aliens and who receive no earned income (within the meaning of section 911(b) and the regulations thereunder) from the employer which constitutes income from sources within the United States (within the meaning of section 861(a)(3) and the regulations thereunder).

(3) *Nondiscriminatory benefits*—(i) *In general.* In general, benefits subject to reimbursement under a plan must not discriminate in favor of highly compensated individuals. Plan benefits will not satisfy the requirements of this subparagraph unless all the benefits provided for participants who are highly compensated individuals are provided for all other participants. In addition, all the benefits available for the dependents of employees who are highly compensated individuals must also be available on the same basis for the dependents of all other employees who are participants. A plan that provides optional benefits to participants will be treated as providing a single benefit with respect to the benefits covered by the option provided that (A) all eligible participants may elect any of the benefits covered by the option and (B) there are either no required employee contributions or the required employee contributions are the same amount. This test is applied to the benefits subject to reimbursement under the plan rather than the actual benefit payments or claims under the plan. The presence or absence of such discrimination will be determined by considering the type of benefit subject to reimbursement provided highly compensated individuals, as well as the amount of the benefit subject to reimbursement. A plan may establish a maximum limit for the amount of reimbursement which may be paid a participant for any single benefit, or combination of benefits. However, any maximum limit attributable to employer contributions must be uniform for all participants and for all dependents of employees who are participants and may not be modified by reason of a participant's age or years of service. In addition, if a plan covers employees who are highly compensated individuals, and the type or the amount of benefits subject to reimbursement under the plan are in proportion to employee compensation, the plan discriminates as to benefits.

(ii) *Discriminatory operation.* Not only must a plan not discriminate on its face in providing benefits in favor of highly compensated individuals, the plan also must not discriminate in favor of such employees in actual operation. The determination of whether plan benefits discriminate in operation in favor of highly compensated individuals is made on the basis of the facts and circumstances of each case. A plan is not considered discriminatory merely because highly compensated individuals participating in the plan utilize a broad range of plan benefits to a greater extent than do other employees participating in the plan. In addition, if a plan (or a particular benefit provided by a plan) is terminated, the termination would cause the plan benefits to be discriminatory if the duration of the plan (or benefit) has the effect of discriminating in favor of highly compensated individuals. Accordingly, the prohibited discrimination may occur where the duration of a particular benefit coincides with the period during which a highly compensated individual utilizes the benefit.

(iii) *Retired employees.* To the extent that an employer provides benefits under a self-insured medical reimbursement plan to a retired employee that would otherwise be excludible from gross income under section 105(b), determined without regard to section 105(h), such benefits shall not be considered a discriminatory benefit under this paragraph (c). The preceding sentence shall not apply to a retired employee who was a highly compensated individual unless the type, and the dollar limitations, of benefits provided retired employees who were highly compensated individuals are the same for all other retired participants. If this subdivision applies to a retired participant, that individual is not considered an employee for

purposes of determining the highest paid 25 percent of all employees under paragraph (d) of this section solely by reason of receiving such plan benefits.

(4) *Multiple plans, etc.*—(i) *General rule.* An employer may designate two or more plans as constituting a single plan that is intended to satisfy the requirements of section 105(h)(2) and paragraph (c) of this section, in which case all plans so designated shall be considered as a single plan in determining whether the requirements of such section are satified by each of the separate plans. A determination that the combination of plans so designated does not satisfy such requirements does not preclude a determination that one or more of such plans, considered separately, satisfies such requirements. A single plan document may be utilized by an employer for two or more separate plans provided that the employer designates the plans that are to be considered separately and the applicable provisions of each separate plan.

(ii) *Other rules.* If the designated combined plan discriminates as to eligibility to participate or benefits, the amount of excess reimbursement will be determined under the rules of section 105(h)(7) and paragraph (e) of this section by taking into account all reimbursements made under the combined plan.

(iii) *H.M.O. participants.* For purposes of section 105(h)(2)(A) and paragraph (c)(2) of this section, a self-insured plan will be deemed to benefit an employee who has enrolled in a health maintenance organization (HMO) that is offered on an optional basis by the employer in lieu of coverage under the self-insured plan if, with respect to that employee, the employer's contributions to the HMO plan equal or exceed those that would be made to the self-insured plan, and if the HMO plan is designated in accordance with subdivision (i) with the self-insured plan as a single plan. For purposes of section 105(h) and this section, except as provided in the preceding sentence, employees covered by, and benefits under, the HMO plan are not treated as part of the self-insured plan.

(d) *Highly compensated individuals defined.* For purposes of section 105(h) and this section, the term "highly compensated individual" means an individual who is—

(1) One of the 5 highest paid officers,

(2) A shareholder who owns (with the application of section 318) more than 10 percent in value of the stock of the employer, or

(3) Among the highest paid 25 percent of all employees (including the 5 highest paid officers, but not including employees excludable under paragraph (c)(2)(iii) of this section who are not participants in any self-insured medical reimbursement plan of the employer, whether or not designated as a single plan under paragraph (c)(4) of this section, or in a health maintenance organization plan).

The status of an employee as an officer or stockholder is determined with respect to a particular benefit on the basis of the employee's officer status or stock ownership at the time during the plan year at which the benefit is provided. In calculating the highest paid 25 percent of all employees, the number of employees included will be rounded to the next highest number. For example, if there are 5 employees, the top two are in the highest paid 25 percent. The level of an employee's compensation is determined on the basis of the employee's compensation for the plan year. For purposes of the preceding sentence, fiscal year plans may determine employee compensation on the basis of the calendar year ending within the plan year.

(e) *Excess reimbursement of highly compensated individual*—(1) *In general.* For purposes of section 105(h) and this section, a reimbursement paid to a highly compensated individual is an excess reimbursement if it is paid pursuant to a plan that fails to satisfy the requirements of paragraph (c)(2) or (c)(3) for the plan year. The amount reimbursed to a highly compensated individual which constitutes an excess reimbursement is not excludable from such individual's gross income under section 105(b).

(2) *Discriminatory benefit.* In the case of a benefit available to highly

compensated individuals but not to all other participants (or which otherwise discriminates in favor of highly compensated individuals as opposed to other participants), the amount of excess reimbursement equals the total amount reimbursed to the highly compensated individual with respect to the benefit.

(3) *Discriminatory coverage.* In the case of benefits (other than discriminatory benefits described in subparagraph (2)) paid to a highly compensated individual under a plan which fails to satisfy the requirements of paragraph (c)(2) relating to nondiscrimination in eligibility to participate, the amount of excess reimbursement is determined by multiplying the total amount reimbursed to the individual by a fraction. The numerator of the fraction is the total amount reimbursed during that plan year to all highly compensated individuals. The denominator of the fraction is the total amount reimbursed during that plan year to all participants. In computing the fraction and the total amount reimbursed to the individual, discriminatory benefits described in subparagraph (2) are not taken into account. Accordingly, any amount which is included in income by reason of the benefit's not being available to all other participants will not be taken into account.

(4) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). Corporation M maintains a self-insured medical reimbursement plan which covers all employees. The plan provides the following maximum limits on the amount of benefits subject to reimbursement: $5,000 for officers and $1,000 for all other participants. During a plan year Employee A, one of the 5 highest paid officers, received reimbursements in the amount of $4,000. Because the amount of benefits provided for highly compensated individuals is not provided for all other participants, the plan benefits are discriminatory. Accordingly, Employee A received an excess reimbursement of $3,000 ($4,000 − $1,000) which constitutes a benefit available to highly compensated individuals, but not to all other participants.

Example (2). Corporation N maintains a self-insured medical reimbursement plan which covers all employees. The plan provides a broad range of medical benefits subject to reimbursement for all participants. However, only the 5 highest paid officers are entitled to dental benefits. During the plan year Employee B, one of the 5 highest paid officers, received dental payments under the plan in the amount of $300. Because dental benefits are provided for highly compensated individuals, and not for all other participants, the plan discriminates as to benefits. Accordingly, Employee B received an excess reimbursement in the amount of $300.

Example (3). Corporation O maintains a self-insured medical reimbursement plan which discriminates as to eligibility by covering only the highest paid 40% of all employees. Benefits subject to reimbursement under the plan are the same for all participants. During a plan year Employee C, a highly compensated individual, received benefits in the amount of $1,000. The amount of excess reimbursement paid Employee C during the plan year will be calculated by multiplying the $1,000 by a fraction determined under subparagraph (3).

Example (4). Corporation P maintains a self-insured medical reimbursement plan for its employees. Benefits subject to reimbursement under the plan are the same for all plan participants. However, the plan fails the eligibility tests of section 105(h)(3)(A) and thereby discriminates as to eligibility. During the 1980 plan year Employee D, a highly compensated individual, was hospitalized for surgery and incurred medical expenses of $4,500 which were reimbursed to D under the plan. During that plan year the Corporation P medical plan paid $50,000 in benefits under the plan, $30,000 of which constituted benefits paid to highly compensated individuals. The amount of excess reimbursement not excludable by D under section 105(b) is $2,700.

$$\left(\$4,500 \times \frac{30,000}{50,000}\right).$$

Example (5). Corporation Q maintains a self-insured medical reimbursement plan for its employees. The plan provides a broad range of medical benefits subject to reimbursement for participants. However, only the five highest paid officers are entitled to dental benefits. In addition, the plan fails the eligibility test of section 105(h)(3)(A) and thereby discriminates as to eligibility. During the calendar 1981 plan year, Employee E, a highly compensated individual, received dental benefits under the plan in the amount of $300, and no other employee received dental benefits. In addition, Employee E was hospitalized for surgery and incurred medical expenses, reimbursement for which was available to all participants, of $4,500 which were reimbursed to E under the plan. Because dental benefits are only provided for highly compensated individuals, Employee E received an excess reim-

bursement under paragraph (e)(2) above in the amount of $300. For the 1981 plan year, the Corporation Q medical plan paid $50,300 in total benefits under the plan, $30,300 of which constituted benefits paid to highly compensated individuals. In computing the fraction under paragraph (e)(3), discriminatory benefits described in paragraph (e)(2) are not taken into account. Therefore, the amount of excess reimbursement not excludable to Employee E with respect to the $4,500 of medical expenses incurred is $2,700

$$\left($4,500 \times \frac{$30,000}{$50,000}\right),$$

and the total amount of excess reimbursements includable in E's income for 1981 is $3,000.

Example (6). (i) Corporation R maintains a calendar year self-insured medical reimbursement plan which covers all employees. The type of benefits subject to reimbursement under the plan include all medical care expenses as defined in section 213(e). The amount of reimbursement available to any employee for any calendar year is limited to 5 percent of the compensation paid to each employee during the calendar year. The amount of compensation and reimbursement paid to Employees A–F for the calendar year is as follows:

Employee	Compensation	Reimbursable amount paid
A	$100,000	$5,000
B	25,000	1,250
C	15,000	750
D	10,000	500
E	10,000	500
F	8,000	400
		8,400

(ii) Because the amount of benefits subject to reimbursement under the plan is in proportion to employee compensation the plan discriminates as to benefits. In addition, Employees A and B are highly compensated individuals. The amount of excess reimbursement paid Employees A and B during the plan year will be determined under paragraph (e)(2). Because benefits in excess of $400 (Employee F's maximum benefit) are provided for highly compensated individuals and not for all other participants, Employees A and B received, respectively, an excess reimbursement of $4,600 and $850.

(f) *Certain controlled groups.* For purposes of applying the provisions of section 105(h) and this section, all employees who are treated as employed by a single employer under section 414 (b) and (c), and the regulations thereunder (relating to special rules for qualified pension, profit-sharing and stock bonus plans), shall be treated as employed by a single employer.

(g) *Exception for medical diagnostic procedures*—(1) *In general.* For purposes of applying section 105(h) and this section, reimbursements paid under a plan for medical diagnostic procedures for an employee, but not a dependent, are not considered to be a part of a plan described in this section. The medical diagnostic procedures include routine medical examinations, blood tests, and X-rays. Such procedures do not include expenses incurred for the treatment, cure or testing of a known illness or disability, or treatment or testing for a physical injury, complaint or specific symptom of a bodily malfunction. For example, a routine dental examination with X-rays is a medical diagnostic procedure, but X-rays and treatment for a specific complaint are not. In addition, such procedures do not include any activity undertaken for exercise, fitness, nutrition, recreation, or the general improvement of health unless they are for medical care as defined in section 213(e). The diagnostic procedures must be performed at a facility which provides no services (directly or indirectly) other than medical, and ancillary, services. For purposes of the preceding sentence, physical proximity between a medical facility and nonmedical facilities will not for that reason alone cause the medical facility not to qualify. For example, an employee's annual physical examination conducted at the employee's personal physician's office is not considered a part of the medical reimbursement plan and therefore is not subject to the nondiscrimination requirements. Accordingly, the amount reimbursed may be excludable from the employee's income if the requirements of section 105(b) are satisfied.

(2) *Transportation, etc. expenses.* Transportation expenses primarily for an allowable diagnostic procedure are included within the exception described in this paragraph, but only to the extent they are ordinary and necessary. Transportation undertaken merely for the general improvement of health, or in connection with a va-

cation, is not within the scope of this exception, nor are any incidental expenses for food or lodging; therefore, amounts reimbursed for such expenses may be excess reimbursements under paragraph (e).

(h) *Time of inclusion.* Excess reimbursments (determined under paragraph (e)) paid to a highly compensated individual for a plan year will be considered as received in the taxable year of the individual in which (or with which) the plan year ends. The particular plan year to which reimbursements relate shall be determined under the plan provisions. In the absence of plan provisions reimbursements shall be attributed to the plan year in which payment is made. For example, under a calendar year plan an excess reimbursement paid to A in 1981 on account of an expense incurred and subject to reimbursement for the 1980 plan year under the terms of the plan will be considered as received in 1980 by A.

(i) *Self-insured contributory plan.* A medical plan subject to this section may provide for employer and employee contributions. See § 1.105–1(c). The tax treatment of reimbursements attributable to employee contributions is determined under section 104(a)(3). The tax treatment of reimbursements attributable to employer contributions is determined under section 105. The amount of reimbursements which are attributable to contributions of the employer shall be determined in accordance with § 1.105–1(e).

(j) *Effective date.* Section 105(h) and this section are effective for taxable years beginning after December 31, 1979 and for amounts reimbursed after December 31, 1979. In determining plan discrimination and the taxability of excess reimbursements made for a plan year beginning in 1979 and ending in 1980, a plan's eligibility and benefit requirements as well as actual reimbursements made in the plan year during 1979, will not be taken into account. In addition, this section does not apply to expenses which are incurred in 1979 and paid in 1980.

(k) *Special rules*—(1) *Relation to cafeteria plans.* If a self-insured medical reimbursement plan is included in a cafeteria plan as described in section 125, the rules of this section will determine the status of a benefit as a taxable or nontaxable benefit, and the rules of section 125 will determine whether an employee is taxed as though he elected all available taxable benefits (including taxable benefits under a discriminatory medical reimbursement plan). This rule is illustrated by the following example:

Example. Corporation M maintains a cafeteria plan described in section 125. Under the plan an officer of the corporation may elect to receive medical benefits provided by a self-insured medical reimbursement plan which is subject to the rules of this section. However, the self-insured medical reimbursement plan fails the nondiscrimination rules under paragraph (c) of this section. Accordingly, the amount of excess reimbursement is taxable to the officer participating in the medical reimbursement plan pursuant to section 105(h) and this section. Therefore, the self-insured medical reimbursement plan will be considered a taxable benefit under section 125 and the regulations thereunder.

(2) *Benefit subject to reimbursement.* For purposes of this section, a benefit subject to reimbursement is a benefit described in the plan under which a claim for reimbursement or for a payment directly to the health service provider may be filed by a plan participant. It does not refer to actual claims or benefit reimbursements paid under a plan.

[T.D. 7754, 46 FR 3505, Jan. 15, 1981]

§ 1.106–1 Contributions by employer to accident and health plans.

The gross income of an employee does not include contributions which his employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred by him, his spouse, or his dependents, as defined in section 152. The employer may contribute to an accident or health plan either by paying the premium (or a portion of the premium) on a policy of accident or health insurance covering one or more of his employees, or by contributing to a separate trust or fund (including a fund referred to in section 105(e)) which provides accident or health benefits directly or

through insurance to one or more of his employees. However, if such insurance policy, trust, or fund provides other benefits in addition to accident or health benefits, section 106 applies only to the portion of the employer's contribution which is allocable to accident or health benefits. See paragraph (d) of § 1.104-1 and §§ 1.105-1 through 1.105-5, inclusive, for regulations relating to exclusion from an employee's gross income of amounts received through accident or health insurance and through accident or health plans.

§ 1.107-1 Rental value of parsonages.

(a) In the case of a minister of the gospel, gross income does not include (1) the rental value of a home, including utilities, furnished to him as a part of his compensation, or (2) the rental allowance paid to him as part of his compensation to the extent such allowance is used by him to rent or otherwise provide a home. In order to qualify for the exclusion, the home or rental allowance must be provided as remuneration for services which are ordinarily the duties of a minister of the gospel. In general, the rules provided in § 1.1402(c)-5 will be applicable to such determination. Examples of specific services the performance of which will be considered duties of a minister for purposes of section 107 include the performance of sacerdotal functions, the conduct of religious worship, the administration and maintenance of religious organizations and their integral agencies, and the performance of teaching and administrative duties at theological seminaries. Also, the service performed by a qualified minister as an employee of the United States (other than as a chaplain in the Armed Forces, whose service is considered to be that of a commissioned officer in his capacity as such, and not as a minister in the exercise of his ministry), or a State, Territory, or possession of the United States, or a political subdivision of any of the foregoing, or the District of Columbia, is in the exercise of his ministry provided the service performed includes such services as are ordinarily the duties of a minister.

(b) For purposes of section 107, the term "home" means a dwelling place (including furnishings) and the appurtenances thereto, such as a garage. The term "rental allowance" means an amount paid to a minister to rent or otherwise provide a home if such amount is designated as rental allowance pursuant to official action taken prior to January 1, 1958, by the employing church or other qualified organization, or if such amount is designated as rental allowance pursuant to official action taken in advance of such payment by the employing church or other qualified organization when paid after December 31, 1957. The designation of an amount as rental allowance may be evidenced in an employment contract, in minutes of or in a resolution by a church or other qualified organization or in its budget, or in any other appropriate instrument evidencing such official action. The designation referred to in this paragraph is a sufficient designation if it permits a payment or a part thereof to be identified as a payment of rental allowance as distinguished from salary or other remuneration.

(c) A rental allowance must be included in the minister's gross income in the taxable year in which it is received, to the extent that such allowance is not used by him during such taxable year to rent or otherwise provide a home. Circumstances under which a rental allowance will be deemed to have been used to rent or provide a home will include cases in which the allowance is expended (1) for rent of a home, (2) for purchase of a home, and (3) for expenses directly related to providing a home. Expenses for food and servants are not considered for this purpose to be directly related to providing a home. Where the minister rents, purchases, or owns a farm or other business property in addition to a home, the portion of the rental allowance expended in connection with the farm or business property shall not be excluded from his gross income.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6691, 28 FR 12817, Dec. 3, 1963]

§ 1.108(a)-1 Income from discharge of indebtedness.

(a) (1) Section 108(a) provides a specific exclusion from gross income, at the taxpayer's election, of the amount of income attributable to the discharge of indebtedness, in whole or in part, within the taxable year. In order to take advantage of the exclusion, the taxpayer must file a consent to applicable regulations relating to the adjustment of basis, in accordance with § 1.108(a)-2. This section applies to indebtedness incurred or assumed either (i) by a corporation, or (ii) by an individual in connection with property used in his trade or business; and it covers any such indebtedness for which the corporate or individual taxpayer is liable or subject to which the taxpayer holds property.

(2) For purposes of section 108(a) and this section, the determination as to whether an indebtedness is incurred or assumed by an individual in connection with property used in his trade or business depends upon the facts of each particular case. Where an indebtedness (whether secured or unsecured) is incurred or assumed by an individual and where the proceeds of such indebtedness are used to purchase, improve, or repair property used in the trade or business, section 108(a) shall apply to the discharge of such indebtedness. However, an indebtedness of an individual will not be considered as incurred in connection with property used in his trade or business merely because it can be shown that the indebtedness was secured by property used in the trade or business.

(b) (1) If, as of the first day of the taxable year in which a discharge of indebtedness occurs, there is unamortized premium, the amount of the income attributable to such premium shall be excluded from gross income. For example: On January 1, 1955, the M Corporation (which files its return on a calendar year basis) had outstanding an issue of A bonds of the face value of $10,000, and as of that day there was $100 unamortized premium on this bond issue. On September 1, 1955, the M Corporation purchased these bonds for $9,000. The total amount to be excluded from gross income under this section is $1,100.

(2) If, as of the first day of the taxable year in which a discharge of indebtedness occurs, there is unamortized discount, the amount of the deduction attributable to such discount shall be disallowed as a deduction. For example: On January 1, 1955, the N Corporation (which files its return on a calendar year basis) had outstanding an issue of B bonds of the face value of $10,000, and as of that day there was $50 unamortized discount on this bond issue. On September 1, 1955, the N Corporation purchased these bonds for $9,000. The total amount to be excluded from gross income under this section is $950.

(c) Section 108(a) and this section are inapplicable in the case of any discharge occurring in any proceeding under section 77B of the Bankruptcy Act (48 Stat. 912, repealed June 22, 1938), under Chapter X or XI of such act (11 U.S.C., ch. 10, 11), or under Chapter XV of such act (53 Stat. 1134, expired July 31, 1940) if the proceeding under such Chapter XV was initiated by a petition filed on or before July 31, 1940, and with respect to any discharge of indebtedness to which section 108(b) applies.

§ 1.108(a)-2 Making and filing of consent.

In order to take advantage of the exclusion from gross income provided by section 108(a), a taxpayer must file with his return for the taxable year a consent to have the basis of his property adjusted in accordance with the regulations prescribed under section 1017 which are in effect at the time of filing such return. See §§ 1.1017-1 and 1.1017-2. In special cases, however, where the taxpayer establishes to the satisfaction of the Commissioner reasonable cause for failure to file the necessary consent with his original return, he may file the consent with an amended return or claim for credit or refund; and in such cases, the consent shall be to the regulations which, at the time of filing the consent, are applicable to the taxable year for which such consent is filed. In all cases the consent shall be made by or on behalf of the taxpayer on Form 982

in accordance with these regulations and the instructions on the form or issued therewith.

[T.D. 6928, 32 FR 13221, Sept. 19, 1967]

§ 1.108(b)–1 Income from discharge of indebtedness of railroad corporations.

(a) Under section 108(b), the amount of any income attributable to the discharge, cancellation, or modification, in whole or in part, within the taxable year, of any indebtedness of a railroad corporation as a result of an order of a court in a receivership proceeding, or in a railroad reorganization proceeding under section 77 of the Bankruptcy Act (11 U.S.C. 205) is excluded from the gross income of the railroad corporation. The section is applicable only in a case where income accrues to a taxpayer from the discharge, modification, or cancellation of the corporate indebtedness (whether in whole or in part) pursuant to a court order.

(b) The railroad corporations to which this section and section 108(b) apply are those defined in section 77(m) of the Bankruptcy Act (11 U.S.C. 205(m)), namely, any common carrier by railroad engaged in the transportation of persons or property in interstate commerce, except a street, a suburban, or interurban electric railway which is not operated as a part of a general railroad system of transportation or which does not derive more than 50 percent of its operating revenues from the transportation of freight in standard steam railroad freight equipment.

(c) As used in section 108(b) and this section, the term "indebtedness" means an obligation, absolute and not contingent, to pay on demand or within a given time, in cash or another medium, a fixed amount.

(d) If, as of the first day of the taxable year in which a discharge of indebtedness occurs, there is unamortized premium, the amount of the income attributable to such premium shall be excluded from gross income. If, as of the first day of the taxable year in which a discharge of indebtedness occurs, there is unamortized discount, the amount of the deduction attributable to such discount shall be disallowed as a deduction. See paragraph (b) of § 1.108(a)–1 for examples illustrating the application of this principle.

(e) The provisions of section 108(b) and this section are applicable with respect to any discharge occurring in a taxable year beginning before January 1, 1958, and for taxable years ending after December 31, 1959, the provisions are applicable with respect to any discharge occurring after December 31, 1959, pursuant to a court proceeding commenced before January 1, 1960.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6528, 26 FR 399, Jan. 19, 1961]

§ 1.109–1 Exclusion from gross income of lessor of real property of value of improvements erected by lessee.

(a) Income derived by a lessor of real property upon the termination, through forfeiture or otherwise, of the lease of such property and attributable to buildings erected or other improvements made by the lessee upon the leased property is excluded from gross income. However, where the facts disclose that such buildings or improvements represent in whole or in part a liquidation in kind of lease rentals, the exclusion from gross income shall not apply to the extent that such buildings or improvements represent such liquidation. The exclusion applies only with respect to the income realized by the lessor upon the termination of the lease and has no application to income, if any, in the form of rent, which may be derived by a lessor during the period of the lease and attributable to buildings erected or other improvements made by the lessee. It has no application to income which may be realized by the lessor upon the termination of the lease but not attributable to the value of such buildings or improvements. Neither does it apply to income derived by the lessor subsequent to the termination of the lease incident to the ownership of such buildings or improvements.

(b) The provisions of this section may be illustrated by the following example:

Example. The A Corporation leased in 1945 for a period of 50 years unimproved real property to the B Corporation under a

lease providing that the B Corporation erect on the leased premises an office building costing $500,000, in addition to paying the A Corporation a lease rental of $10,000 per annum beginning on the date of completion of the improvements, the sum of $100,000 being placed in escrow for the payment of the rental. The building was completed on January 1, 1950. The lease provided that all improvements made by the lessee on the leased property would become the absolute property of the A Corporation on the termination of the lease by forfeiture or otherwise and that the lessor would become entitled on such termination to the remainder of the sum, if any, remaining in the escrow fund. The B Corporation forfeited its lease on January 1, 1955, when the improvements had a value of $100,000. Under the provisions of section 109, the $100,000 is excluded from gross income. The amount of $50,000 representing the remainder in the escrow fund is forfeited to the A Corporation and is included in the gross income of that taxpayer. As to the basis of the property in the hands of the A Corporation, see § 1.1019–1.

§ 1.110–1 Income taxes paid by lessee corporation.

(a) If a lease was entered into before January 1, 1954, if both lessee and lessor are corporations, and if, under the lease, the lessee is obligated to pay, or to reimburse the lessor for, any portion of the tax imposed by subtitle A of the Code upon the lessor with respect to the rentals derived by the lessor from such lease, such payment or reimbursement of tax shall be excluded from gross income of the lessor and no deduction therefor shall be allowed to the lessee. For purposes of this section, a renewal or continuance after December 31, 1953, of a lease entered into before January 1, 1954, shall be considered a lease entered into before January 1, 1954, if such renewal or continuance is made in accordance with an option contained in the original lease on December 31, 1953, or in accordance with an option contained (on December 31, 1953) in an instrument by which the original lease was renewed or continued. Thus, assume that a corporation lessor and a corporation lessee enter into a lease on January 1, 1947. The lease expires on December 31, 1953, but may be renewed for two years at the option of the lessee. On December 31, 1955, the lessee exercises his option, and the parties further agree, in writing, that the terms of the lease may be extended for an additional two years at the lessee's option. On December 31, 1955, the lessee exercises his option. The renewal period covering 1954 and 1955 are controlled by the provisions of section 110. Similarly, section 110 is applicable to the second two-year period to which the lease has been extended. However, section 110 would not be applicable to any further extension of the terms of the lease, since such further extension would not be made pursuant to an option existing on December 31, 1953.

(b) In the case of a lease to which the provisions of section 110 are not applicable, any amounts paid or reimbursed by the lessee corporation with respect to taxes imposed by subtitle A of the Code upon the lessor corporation for rentals derived by the lessor corporation under such lease shall be included in the gross income of the lessor corporation and shall, if otherwise allowable, be allowed as a deduction to the lessee corporation.

§ 1.111–1 Recovery of certain items previously deducted or credited.

(a) *General.* Section 111 provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127 of the Internal Revenue Code of 1939, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. The term "recovery exclusion" as used in this section means an amount equal to the portion of the bad debts, prior taxes, and delinquency amounts (the items specifically referred to in section 111), and of all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under subtitle A (other

than the accumulated earnings tax imposed by section 531 or the personal holding company tax imposed by section 541) of the Internal Revenue Code of 1954 or corresponding provisions of prior income tax laws (other than the World War II excess profits tax imposed under subchapter E, chapter 2 of the Internal Revenue Code of 1939).

(1) *Section 111 items.* The term "section 111 items" as used in this section means bad debts, prior taxes, delinquency amounts, and all other items subject to the rule of exclusion, for which a deduction or credit was allowed for a prior taxable year. If a bad debt was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts, it was not deducted, and it is therefore not considered a section 111 item. Bad debts, prior taxes, and delinquency amounts are defined in section 111(b)(1), (2), and (3), respectively. An example of a delinquency amount is interest on delinquent taxes. An example of the other items not expressly referred to in section 111 but nevertheless subject to the rule of exclusion is a loss sustained upon the sale of stock and later recovered, in whole or in part, through an action against the party from whom such stock had been purchased.

(2) *Definition of "recovery".* Recoveries result from the receipt of amounts in respect of the previously deducted or credited section 111 items, such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued. Care should be taken in the case of bad debts which were treated as only partially worthless in prior years to distinguish between the item described in section 111, that is, the part of such debt which was deducted, and the part not previously deducted, which is not a section 111 item and is considered the first part collected. The collection of the part not deducted is not considered a "recovery". Furthermore, the term "recovery" does not include the gain resulting from the receipt of an amount on account of a section 111 item which, together with previous such receipts, exceeds the deduction or credit previously allowed for such item. For instance, a $100 corporate bond purchased for $40 and later deducted as worthless is subsequently collected to the extent of $50. The $10 gain (excess of $50 collection over $40 cost) is not a recovery of a section 111 item. Such gain is in no case excluded from gross income under section 111, regardless of whether the $40 recovery is or is not excluded.

(3) *Treatment of debt deducted in more than one year by reason of partial worthlessness.* In the case of a bad debt deducted in part for two or more prior years, each such deduction of a part of the debt is considered a separate section 111 item. A recovery with respect to such debt is considered first a recovery of those items (or portions thereof), resulting from such debt, for which there are recovery exclusions. If there are recovery exclusions for two or more items resulting from the same bad debt, such items are considered recovered in the order of the taxable years for which they were deducted, beginning with the latest. The recovery exclusion for any such item is determined by considering the recovery exclusion with respect to the prior year for which such item was deducted as being first used to offset all other applicable recoveries in the year in which the bad debt is recovered.

(4) *Special provisions as to worthless bonds, etc., which are treated as capital losses.* Certain bad debts arising from the worthlessness of securities and certain nonbusiness bad debts are treated as losses from the sale or exchange of capital assets. See sections 165(g) and 166(d). The amounts of the deductions allowed for any year under section 1211 on account of such losses for such year are considered to be section 111 items. Any part of such losses which, under section 1211, is a deduction for a subsequent year through the capital loss carryover (any later receipt of an amount with respect to such deducted loss is a recovery) is considered a section 111 item for the year in which such loss was sustained.

(b) *Computation of recovery exclusion*—(1) *Amount of recovery exclusion allowable for year of recovery.* For the year of any recovery, the section 111 items which were deducted or credited for one prior year are considered as a

group and the recovery thereon is considered separately from recoveries of any items which were deducted or credited for other years. This recovery is excluded from gross income to the extent of the recovery exclusion with respect to this group of items as (i) determined for the original year for which such items were deducted or credited (see subparagraph (2) of this paragraph) and (ii) reduced by the excludable recoveries in intervening years on account of all section 111 items for such original year. A taxpayer claiming a recovery exclusion shall submit, at the time the exclusion is claimed, the computation of the recovery exclusion claimed for the original year for which the items were deducted or credited, and computations showing the amount recovered in intervening years on account of the section 111 items deducted or credited for the original year.

(2) *Determination of recovery exclusion for original year for which items were deducted or credited.* (i) The recovery exclusion for the taxable year for which section 111 items were deducted or credited (that is, the "original taxable year") is the portion of the aggregate amount of such deductions and credits which could be disallowed without causing an increase in any tax of the taxpayer imposed under subtitle A (other than the accumulated earnings tax imposed by section 531 or the personal holding company tax imposed by section 541) of the Internal Revenue Code of 1954 or corresponding provisions of prior income tax laws (other than the World War II excess profits tax imposed under subchapter E, chapter 2 of the Internal Revenue Code of 1939). For the purpose of such recovery exclusion, consideration must be given to the effect of net operating loss carryovers and carrybacks or capital loss carryovers.

(ii) This rule shall be applied by determining the recovery exclusion as the aggregate amount of the section 111 items for the original year for which such items were deducted or credited reduced by whichever of the following amounts is the greater:

(*a*) The difference between (*1*) the taxable income for such original year and (*2*) the taxable income computed without regard to the section 111 items for such original year.

(*b*) In the case of a taxpayer subject to any income tax in lieu of normal tax or surtax or both (except the alternative tax on capital gains imposed by section 1201, which is disregarded), the difference between (*1*) the income subject to such tax for such original year and (*2*) the income subject to such tax computed without regard to the section 111 items for such original year.

(Neither the amount determined under (*1*) nor the amount under (*2*) of (*a*) or (*b*) of this subdivision shall in any case be considered less than zero.) For this determination of the recovery exclusion, the aggregate of the section 111 items must be further decreased by the portion thereof which caused a reduction in tax in preceding or succeeding taxable years through any net operating loss carryovers or carrybacks or capital loss carryovers affected by such items. This decrease is the aggregate of the largest amount determined for each of such preceding and succeeding years under (*a*) and (*b*) of this subdivision, the computation of each carryover or carryback to the preceding or succeeding year being made under (*1*) of (*a*) and (*b*) of this subdivision with regard to the section 111 items for the original year and such computation being made under (*2*) of (*a*) and (*b*) of this subdivision without regard to such items. For the purpose of the preceding sentence, the computations under both (*1*) and (*2*) of (*a*) and (*b*) of this subdivision shall be made without regard to any section 111 items for such preceding or succeeding year and the carryovers and carrybacks to such year shall be determined without regard to any section 111 items for years subsequent to the original year.

(iii) The determination of the recovery exclusion for original taxable years subject to the provisions of the Internal Revenue Code of 1939 shall be made under 26 CFR (1939) 39.22(b)(12)-1(b)(2) (Regulations 118).

(3) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. A single individual with no dependents has for his 1954 taxable year the following income and deductions:

	With deduction of section 111 items	Without deduction of section 111 items
Gross income	$25,000	$25,000
Less deductions:		
Depreciation	20,000	20,000
Business bad debts and taxes	6,300	
Personal exemption	600	600
	26,900	20,600
Taxable income or (loss)	(1,900)	4,400
Adjustment under section 172(d)(3)	600	
Net operating loss	(1,300)	

The full amount of the net operating loss of $1,300 is carried back and allowed as a deduction for 1952. The aggregate of the section 111 items for 1954 is $6,300 (bad debts and taxes). The recovery exclusion on account of section 111 items for 1954 is $600, determined by reducing the $6,300 aggregate of the section 111 items by $5,700, i.e., the sum of (1) the difference between the amount of the taxable income for 1954 computed without regard to the section 111 items ($4,400) and the amount of the taxable income for 1954 (not less than zero) computed by taking such items into account, and (2) the amount of the net operating loss ($1,300) which caused the reduction in tax for 1952 by reason of the carryback provisions. If in 1956 the taxpayer recovers $400 of the bad debts, all of the recovery is excluded from the income by reason of the recovery exclusion of $600 determined for the original year 1954. If in 1957 the taxpayer recovers an additional $300 of the bad debts, only $200 is excluded from gross income. That is, the recovery exclusion of $600 determined for the original year 1954 is reduced by the $400 recovered in 1956, leaving a balance of $200 which is used in 1957. The balance of the amount recovered in 1957, $100 ($300 less $200), is included in gross income for 1957.

(c) *Provisions as to taxes imposed by section 531 (relating to the accumulated earnings tax) and section 541 (relating to the tax on personal holding companies).* A recovery exclusion allowed for purposes of subtitle A (other than section 531 or section 541) of the Internal Revenue Code of 1954 shall also be allowed for the purpose of determining the accumulated earnings tax under section 531 or the personal holding company tax under section 541 regardless of whether or not the section 111 items on which such recovery exclusion is based resulted in a reduction of the tax under section 531 or section 541 of the Internal Revenue Code of 1954 (or corresponding provisions of prior income tax laws) for the prior taxable year. Furthermore, if there is recovery of a section 111 item which was not allowable as a deduction or credit for the prior taxable year for purposes of subtitle A (not including section 531 or section 541) or corresponding provisions of prior income tax laws (other than subchapter E, chapter 2 of the Internal Revenue Code of 1939, relating to World War II excess profits tax), but was allowable for such prior taxable year in determining the tax under section 531 or section 541 (or corresponding provisions of prior income tax laws) then for the purpose of determining the tax under section 531 or section 541 a recovery exclusion shall be allowable with respect to such recovery if the section 111 item did not result in a reduction of the tax under section 531 or section 541 (or corresponding provisions of prior income tax laws).

§ 1.112-1 Compensation of members of the Armed Forces of the United States for service in a combat zone during an induction period, or for service while hospitalized as a result of such combat-zone service.

(a) In addition to the exemptions and credits otherwise applicable, section 112 provides that there shall be excluded from gross income:

(1) Compensation received for active service as a member below the grade of commissioned officer in the Armed Forces of the United States for any month during any part of which such member (i) served in a combat zone during an induction period, or (ii) was hospitalized at any place as a result of wounds, disease, or injury incurred while so serving provided that during all of such month there are combatant activities in some combat zone.

(2) In the case of compensation received for active service as a commissioned officer in the Armed Forces of the United States for any month during any part of which such officer (i) served in a combat zone during an

induction period, or (ii) was hospitalized at any place as a result of wounds, disease, or injury incurred while so serving: *Provided,* That during all of such month there are combatant activities in some combat zone, so much of such compensation as does not exceed—

(i) $500, received in taxable years ending after December 31, 1965, for periods of active service after that date, and

(ii) $200, whenever received, for periods of active service before January 1, 1966, or, received in taxable years ending before that date, for periods of active service on or after that date.

(b) The exclusions under section 112 and this section are applicable only if active service is performed in a combat zone during an induction period. Compensation is subject to exclusion whether or not it is received outside a combat zone or while the recipient is hospitalized or in a year different from that in which the service was rendered for which the compensation is paid. Service is performed in a combat zone only if it is performed in an area which the President of the United States has designated by Executive order, for the purpose of section 112, as an area in which Armed Forces of the United States are or have engaged in combat, and only if it is performed on or after the date designated by the President by Executive order as the date of the commencing of combatant activities in such zone and on or before the date designated by the President by Executive order as the date of the termination of combatant activities in such zone. Section 112(c)(3) provides that June 25, 1950, shall be considered the date of commencing of combatant activities in the combat zone designated in Executive Order 10195 (3 CFR, 1949-1953 Comp., 373). In Executive Order 10585 (3 CFR, 1955 Supp. 51), the President designated January 31, 1955, as of midnight thereof, as the date of termination of combatant activities in the combat zone designated in Executive Order 10195. If a member of the Armed Forces serves in a combat zone for any part of a month during an induction period, he is entitled to the exclusion for such month to the same extent as if he has served in such zone, for the entire month. If a member of the Armed Forces is hospitalized for a part of a month as a result of wounds, disease, or injury incurred while serving in such zone during an induction period, he is entitled to the exclusion for the entire month provided there are some combatant activities in any combat zone during all of such month.

(c) If an individual is hospitalized for wound, disease, or injury while serving in a combat zone, the wound, disease, or injury will, unless the contrary clearly appears, be presumed to have been incurred while serving in a combat zone. In certain cases, however, a wound, disease, or injury may have been incurred while serving. And in exceptional cases, a wound, disease, or injury will not have been incurred while serving in a combat zone even though the individual was hospitalized for it while so serving.

(d) These principles may be illustrated by the following examples (in each case service is performed in a combat zone during an induction period):

Example (1). An individual is hospitalized in a combat zone for a specific disease after having served in such zone for three weeks. The incubation period of such disease is from two to four weeks. Such disease was incurred while serving in the combat zone.

Example (2). The facts are the same as in example (1) except that the incubation period is one year. Such disease was not incurred while serving in the combat zone.

Example (3). A member of the Air Force, stationed outside the combat zone, is shot while participating in an aerial flight over the combat zone, but is not hospitalized until he returns to his home base. Such injury was incurred while serving in a combat zone.

Example (4). An individual is hospitalized for a specific disease three weeks after having departed from a combat zone. The incubation period of such disease is from two to four weeks. Such disease was incurred while serving in a combat zone.

(e) An individual is hospitalized only until such time as his status as a hospital patient ceases by reason of his discharge from the hospital.

(f) The term "induction period" means any period in which individuals are generally subject to induction into the Armed Forces of the United States under the Universal Military Training

and Service Act (50 App. U.S.C. 451) or under similar acts hereafter enacted. The term does not apply to any period in which individuals are not generally subject to induction but are subject to induction by reason of a prior deferment.

(g) The term "commissioned officer" does not include a commissioned warrant officer, and, accordingly, a commissioned warrant officer is entitled to the exclusion allowed to enlisted personnel under section 112(a). The term "compensation", for the purpose of this section, does not include pensions and retirement pay. As to who are members of the Armed Forces of the United States, see section 7701(a)(15).

(h) These exclusions are applicable without regard to the marital status of the recipient of the compensation, and if a husband and wife both meet the requirements of the statute, then each is entitled to the benefit of an exclusion. In the case of a husband and wife domiciled in a State recognized for Federal income tax purposes as a community property State, any exclusion from gross income under section 112 operates before apportionment of the gross income of the spouses in accordance with community property law. For example, a man and his wife are domiciled in a community property State and he is entitled, as a commissioned officer, to the benefit of the exclusion under section 112(b) of $500 for each month, with respect to compensation received in taxable years ending after December 31, 1965, for periods of active service after that date. He receives $2,100 as compensation for such active service for 3 months in a combat zone. Of such amount, $1,500 is excluded from gross income under section 112(b) and only $600 is taken into account in determining the gross income of both husband and wife.

(i) A member of the Armed Forces is in active service if he is actually serving in the Armed Forces of the United States. Periods during which a member of the Armed Forces is absent from duty on account of sickness, wounds, leave, internment by the enemy, or other lawful cause are periods of active service. A member of the Armed Forces in active service in a combat zone who there becomes a prisoner of war or missing in action is deemed, for the purpose of section 112 and this section, to continue in active service in the combat zone for the period for which he is entitled to such status for military pay purposes. These exclusions apply to compensation received by a member of the Armed Forces for services rendered while in active service even though payment is received subsequent to discharge or release from active service. Compensation credited to a decedent's account for a period subsequent to the established date of his death and received by his estate will be excluded under section 112 from the gross income of the estate to the same extent that it would have been excluded from the gross income of the decedent if he had lived and received such compensation.

(j) (1) For purposes of section 112 and this section, members of the Armed Forces who perform military service in an area outside an area designated as a combat zone by Executive order, which service is in direct support of military operations in such zone and is performed under conditions which qualify such members for Hostile Fire Pay (as authorized under section 9(a) of the Uniformed Services Pay Act of 1963 (37 U.S.C. 310)), shall, during the period of such qualifying service, be deemed to have served in such combat zone.

(2) The application of this paragraph may be illustrated by the following examples:

Example (1). On April 24, 1965, an Executive order designated Vietnam and certain adjacent waters as a combat zone, retroactive to January 1, 1964. In May 1970, units of the Armed Forces assigned to Vietnam crossed into Cambodia from Vietnam. This operation was in direct support of military operations in Vietnam. A is a member of the Armed Forces assigned to a ground unit stationed in Vietnam. A along with his unit performed military service in Cambodia from May 1, 1970, through May 12, 1970, under conditions which qualified him for Hostile Fire Pay (as authorized under section 9(a) of the Uniformed Services Pay Act of 1963 (37 U.S.C. 310)). A is deemed to have served in the Vietnamese combat zone from May 1, 1970, through May 12, 1970. Accordingly, A is entitled to the benefits of section

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112 (certain combat pay of members of the Armed Forces) for the month of May 1970.

Example (2). The facts are the same as in example (1) except that A incurred wounds on May 11, 1970, while performing military service in Cambodia under conditions which, at the time he incurred such wounds, qualified him for Hostile Fire Pay (as authorized under section 9(a) of the Uniformed Services Pay Act of 1963 (37 U.S.C. 310)). Accordingly, A is deemed to have incurred such wounds while serving in the Vietnamese combat zone and is entitled to the benefits of section 112 (certain combat pay of members of the Armed Forces).

Example (3). The facts are the same as in example (1) except that A is stationed in Thailand as a member of a ground crew servicing combat aircraft operating in Vietnam, Laos, and Cambodia. During May 1970, A does not qualify for Hostile Fire Pay (as authorized under section 9(a) of the Uniformed Services Pay Act of 1963 (37 U.S.C. 310)). Accordingly, A is not deemed to have served in the Vietnamese combat zone during May 1970, and is not entitled to the benefits of section 112 (certain combat pay of members of the Armed Forces).

Example (4). The facts are the same as in example (1) except that A is assigned to an air unit stationed in Thailand. In May 1970, members of air units of the Armed Forces stationed in Thailand flew combat and supply missions into and over Cambodia from Thailand in direct support of military operations in Vietnam. A flew combat missions over Cambodia from Thailand from May 1, 1970, to May 8, 1970, under conditions which qualified him for Hostile Fire Pay (as authorized under section 9(a) of the Uniformed Services Pay Act of 1963 (37 U.S.C. 310)). Accordingly, A is deemed to have served in the Vietnamese combat zone from May 1, 1970, through May 8, 1970. Thus, A qualifies for the benefits of section 112 (certain combat pay of members of the Armed Forces) for the month of May 1970. The result would be the same if A flew supply missions into Cambodia from Thailand from May 1, 1970, through May 8, 1970, which qualified him for Hostile Fire Pay (as authorized under section 9(a) of the Uniformed Services Pay Act of 1963 (37 U.S.C. 310)).

Example (5). The facts are the same as in example (4) except that on May 8, 1970, A was killed when his plane crashed on returning to the airbase in Thailand. Since A was performing military service under conditions which at the time of his death would have qualified him for Hostile Fire Pay (as authorized under section 9(a) of the Uniformed Services Pay Act of 1963 (37 U.S.C. 310)), he is deemed to have died while serving in the Vietnamese combat zone or to have died as the result of wounds, disease, or injury incurred while serving in such combat zone. Accordingly, A qualifies for the benefits of section 692 (income taxes on members of the Armed Forces on death) and section 2201 (members of the Armed Forces dying during an induction period). The result would be the same if, on May 8, 1970, A flew a supply mission into Cambodia from Thailand and A was killed when his plane crashed on returning to the airbase in Thailand.

Example (6). The facts are the same as in example (4) except that on May 8, 1970, A was killed as the result of an automobile accident while leaving the airbase in Thailand shortly after returning from a mission over Cambodia. Since A was not performing a military duty at the time of his death which would have qualified him for Hostile Fire Pay (as authorized under section 9(a) of the Uniformed Services Pay Act of 1963 (37 U.S.C. 310)), he is not deemed to have died while serving in the Vietnamese combat zone or to have died as the result of wounds, disease, or injury incurred while serving in such combat zone. Accordingly, A does not qualify for the benefits of section 692 (income taxes on members of Armed Forces on death) or section 2201 (members of the Armed Forces dying during an induction period).

(k) (1) For periods after November 11, 1970, members of the Armed Forces who:

(i) Are present in a combat zone while on leave from a duty station which is located outside a combat zone, or

(ii) Pass over or through a combat zone during the course of a trip between two points both of which lie outside a combat zone, or

(iii) Are present in a combat zone solely for their own personal convenience, shall not be considered to have "served in a combat zone" within the meaning of paragraph (1) of subsection (a) or (b) of section 112 or to have been hospitalized as a result of wounds, disease, or injury incurred "while serving in a combat zone" within the meaning of paragraph (2) of subsection (a) or (b) of section 112.

(2) This paragraph shall not apply to members of the Armed Forces who:

(i) Are assigned on official temporary duty to a combat zone, or

(ii) Qualify for Hostile Fire Pay (as authorized under section 9(a) of the Uniformed Services Pay Act of 1963 (37 U.S.C. 310)) as a result of presence in a combat zone.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). On April 24, 1965, an Executive order designated Vietnam and certain adjacent waters as a combat zone, retroactive to January 1, 1964. A is a member of the Armed Forces assigned to a unit stationed in Okinawa. On December 10, 1970, A voluntarily visits Vietnam while on leave. A is not considered to have "served in a combat zone" while in Vietnam since he was present in a combat zone while on leave from a duty station located outside a combat zone.

Example (2). The facts are the same as in example (1) except that, due to unusual circumstances, A is subject to hostile fire while on leave in Vietnam. For that reason, A qualifies for Hostile Fire Pay (as authorized under section 9(a) of the Uniformed Services Pay Act of 1963 (37 U.S.C. 310)). A is therefore deemed to have "served in a combat zone" while in Vietnam during December 1970. Accordingly, A qualifies for the benefits of section 112 (certain combat pay of members of the Armed Forces). If A had been killed or had died as a result of wounds due to such hostile fire, he would have qualified for the benefits of section 692 (income taxes on members of Armed Forces on death) and section 2201 (members of the Armed Forces dying during an induction period).

Example (3). The facts are the same as in example (1) except that A is assigned to a ground unit stationed in Vietnam. During December 1970, A takes authorized leave and elects to spend the leave period in Vietnam. A is not on leave from a duty station located outside a combat zone nor is he present in the combat zone solely for his own personal convenience. Accordingly, A's combat zone tax benefits continue while he is on leave in Vietnam.

Example (4). The facts are the same as in example (1) except that A is assigned as a navigator to an air unit station in Okinawa. On December 1, 1970, during the course of a flight between A's home base in Okinawa and another base in Thailand the aircraft on which A is serving as a navigator flew over Vietnam. A does not qualify for Hostile Fire Pay (as authorized under section 9(a) of the Uniformed Services Pay Act of 1963 (37 U.S.C. 310)) as a result of such flight. Accordingly, A is not considered to have "served in a combat zone" as a result of flying over Vietnam since he passed over a combat zone during the course of a trip between two points both of which lie outside a combat zone without having qualified for Hostile Fire Pay.

Example (5). The facts are the same as in example (1) except that A enters Vietnam on a 3-day pass. A arrived in Saigon on November 30, 1970, and departed from Saigon on December 1, 1970. A did not qualify for Hostile Fire Pay (as authorized under section 9(a) of the Uniformed Services Pay Act of 1963 (37 U.S.C. 310)) while he was present in Vietnam. Accordingly, A is not considered to have "served in a combat zone" while in Vietnam since he was present in a combat zone solely for his own personal convenience.

Example (6). The facts are the same as in example (1) except that A is a military courier assigned on official duty to deliver military pouches in Saigon and in Bangkok. On December 20, 1970, A arrived in Saigon from Tokyo and on December 21, 1970, A departed for Bangkok. Although he passed through Vietnam during the course of a trip between two points outside Vietnam, A is nevertheless considered to have "served in a combat zone" while in Vietnam because he was assigned on official temporary duty to a combat zone.

Example (7). The facts are the same as in example (1) except that while in Saigon A is wounded by hostile fire and therefore qualifies for Hostile Fire Pay (as authorized under section 9(a) of the Uniformed Services Pay Act of 1963 (37 U.S.C. 310)). Although he was present in Vietnam while on leave from a duty station outside Vietnam, A qualifies for the benefits of section 112 (certain combat pay of members of the Armed Forces) because he qualified for Hostile Fire Pay (as authorized under section 9(a) of the Uniformed Services Pay Act of 1963 (37 U.S.C. 310)) while in Vietnam.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6906, 31 FR 16615, Dec. 29, 1966; T.D. 7066, 35 FR 17327, Nov. 11, 1970; 35 FR 18195, Nov. 28, 1970]

§ 1.113–1 Mustering-out payments for members of the Armed Forces.

For the purposes of the exclusion from gross income under section 113 of mustering-out payments with respect to service in the Armed Forces, mustering-out payments are payments made to any recipients pursuant to the provisions of 38 U.S.C. 2105 (formerly section 5 of the Mustering-out Payment Act of 1944 and section 505 of the Veterans' Readjustment Assistance Act of 1952).

§ 1.114–1 Proceeds from certain sports programs conducted for the benefit of the American National Red Cross.

(a) *In general.* Under section 114, a corporation primarily engaged in the furnishing of sports programs may ex-

clude from its gross income amounts received as proceeds from a sports program conducted by such corporation if each of the following requirements is met:

(1) The corporation agrees in writing with the American National Red Cross to conduct such sports program exclusively for the benefit of the American National Red Cross;

(2) The corporation turns over to the American National Red Cross all the proceeds from such sports program, less only the expenses paid or incurred by such corporation which would not have been paid or incurred but for such sports program and which would be allowable as deductions as ordinary and necessary business expenses under section 162(a) except for the provisions of section 114(b); and

(3) The facilities of the corporation used in conducting such sports program are not regularly used during the taxable year for the conduct of sports programs to which section 114(a) applies.

(b) *Certain corporations ineligible.* Section 114 does not apply in the case of a corporation organized or operated primarily to conduct or furnish, or to participate in the conduct or furnishing of, one or more sports programs for the American National Red Cross.

(c) *Proceeds from a sports program.* The proceeds from a sports program conducted for the benefit of the American National Red Cross include all amounts received by the conducting corporation, irrespective of when received, on account of such sports program, which amounts would be includible in the gross income of such conducting corporation, except for the provisions of section 114. Where the activities carried on in connection with the sports program include the sale or rental of radio, television, or movie rights, refreshments, souvenirs, parking facilities, programs, advertising, or other goods and services, whether sold or rented directly or through concessionaries, the amounts received by the conducting corporation from such sports program include all amounts received from such activities, but only where such amounts would not have been received by the conducting corporation but for the presentation of the particular sports program. Where the conducting corporation receives payments for concessions on an annual or seasonal basis, and such payments are not increased because of the particular sports program, such payments are not considered as proceeds from such sports program, and any expenses paid or incurred by the conducting corporation on account of such concession operations may not be taken into account under section 114(a)(2) in determining the net amount of the proceeds from such sports program which the conducting corporation is required to turn over to the American National Red Cross; nor are the proceeds of a sports program considered to include amounts received by the conducting corporation which do not constitute gross income of such corporation, such as admissions taxes or the breakage on a pari-mutual wagering pool which is required to be paid over to the State.

(d) *Sports programs.* (1) Section 114 applies where the program furnished by the conducting corporation consists of sports events such as baseball, football, basketball, or racing but it does not apply to programs or events such as motion pictures, circuses, or dances which are not ordinarily considered to be competitive sporting events.

(2) A sports program includes all of the events normally making up a full program in the particular sport. A single race of a racing program consisting of more than one race would not constitute a sports program, nor would one baseball or basketball game of a doubleheader program constitute a sports program.

(e) *Treatment of expenses.* Expenses described in section 114(a)(2) shall be allowable as deductions under section 162 only to the extent that such expenses exceed the amount excluded from gross income under section 114(a).

§ 1.115–1 Bridges to be acquired by State or political subdivisions.

(a) Any State or political subdivision thereof claiming a refund under the provisions of section 115(c) of an amount equal to all or a portion of any income tax levied, assessed, collected,

and paid shall file a claim therefor on Form 843 (to which there shall be attached as exhibits the matter hereinafter prescribed) with the district director for the internal revenue district in which the tax was paid, which claim shall be executed on behalf of such State or political subdivision thereof by the treasurer or other fiscal officer thereof and shall contain:

(1) A statement of the name of the taxpayer, of the amount of tax levied, assessed, collected, and paid for the taxable year or period in respect of which the claim is made, and the amount of refund thereby sought;

(2) A full statement of the facts considered by the claimant sufficient to entitle it to receive the refund, including copies of all contracts and other documents bearing on the case, and a statement that the claim is submitted under the provisions of section 115(c);

(3) A showing which will establish to the satisfaction of the district director that the fiscal officer presenting the claim has authority to receive the amount of the refund on behalf of the State or political subdivision which he assumes to represent and to apply without delay the entire amount of such refund in part payment for the acquisition of such bridge, including copies of the laws, ordinances, or similar enactments considered by the claimant sufficient to establish its authority to receive the refund and so to apply it, together with a statement that such fiscal officer will receive and immediately so apply the entire amount of the refund; and

(4) A statement, verified by a written declaration that it is made under the penalties of perjury, made by or on behalf of the taxpayer that the taxpayer thereby joins with and concurs in the request of the State or political subdivision thereof that a refund of an amount equal to all or a portion of the tax previously paid by such taxpayer be made to such State or political subdivision, that the taxpayer agrees to receive the amounts refunded from the State or political subdivision to which it is paid and immediately to apply the entire amount of such refund in part payment for the acquisition of such bridge, and that if for any reason the contract which is the basis of the claim for refund is not fully executed and performed, the taxpayer will repay to the United States upon its demand the entire amount of the refund with interest at the annual rate referred to in the regulations under section 6621 from the date the refund is made without seeking or claiming the benefit of any statute of limitations which prior thereto may have run against the United States.

(b) No refund shall be made of any amount in excess of the amount of the tax levied, assessed, collected, and paid by the taxpayer for any taxable year or period. A separate claim shall be made in respect of each separate taxable year or period. If by the terms of the contract on which the claim is based two or more States or political subdivisions of a State or States are entitled to acquire the bridge, the claim for refund in respect of each separate taxable year or period must be made jointly by the States or political subdivisions thereof so entitled. The amount refunded under section 115(c) and this section is not considered an overpayment, within the meaning of section 6611 relating to interest on overpayments, and no interest shall be allowed or paid upon the amount of the refund.

(c) A check or voucher in payment of a claim for refund allowed under section 115(c) will be drawn in the name of the fiscal officer or officers having authority, as established under paragraph (a)(3) of this section, to receive the same, and will contain an express provision that it is issued for the sole purpose and subject to the conditions prescribed in section 115(c) and this section.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, as amended by T.D. 7384, 40 FR 49321, Oct. 22, 1975]

§ 1.116–1 Partial exclusion of dividends.

(a) *In general.* Section 116 excludes from gross income the first $100 ($50 for dividends received in a taxable year which ends after July 31, 1954 and begins before January 1, 1964, whether or not the dividend is received after July 31, 1954) of dividends from domestic corporations received

by an individual in a taxable year beginning after December 31, 1963.

(b) *Joint returns of husband and wife.* In the case of a joint return of husband and wife, each spouse is entitled to the exclusion in an amount not in excess of $100 ($50 for dividends received in taxable years beginning before January 1, 1964), with respect to the dividends received by such spouse. Thus, if in the calendar year 1955, a husband receives $200 of dividends and his wife $100, the amount to be included in gross income is $200 ($150 of the husband's dividends and $50 of the wife's dividends). If the amounts are received in a taxable year beginning after December 31, 1963, the amount to be included in gross income is $100 ($100 of the husband's dividends and none of the wife's dividends). If the wife receives only $30 of dividends, the entire $30 is excludable, and there is included in gross income in the joint return in the case of a taxable year beginning before January 1, 1964, only $150 ($200 less his $50 exclusion) or in the case of a taxable year beginning after December 31, 1963, only $100 ($200 less his $100 exclusion) consisting of the dividends received by the husband.

(c) *Individuals receiving dividends.* Where two or more persons hold stock as tenants in common, as joint tenants, or as tenants by the entirety, the dividends received with respect to such stock shall be considered as being received by each tenant to the extent that he is entitled under local law to a share of such dividends. Where dividends constitute community property under local law each spouse shall be considered as receiving one-half of such dividends.

(d) *Dividends to which the exclusion applies*—(1) *General rule.* The exclusion under section 116 applies only to distributions of property defined as dividends by section 316. Thus, the exclusion is not allowed with respect to patronage dividends paid by either exempt or taxable farm cooperatives. Nor is it allowed for distributions to nonstockholding policy holders by an insurance company having shares of stock or for any distribution by a mutual insurance company. See subparagraph (2)(i) of this paragraph for an additional restriction with respect to stock life insurance companies. The exclusion is, however, allowed with respect to dividends paid on capital stock by nonexempt cooperatives and with respect to dividends paid on capital stock by building and loan associations. However, see subparagraph (2)(ii) of this paragraph with respect to so-called dividends paid by building and loan associations ineligible for the exclusion. The exclusion is allowed with respect to distributions from any organization taxed as a corporation if the distribution falls within the definition of a dividend in section 316.

(2) *Dividends from certain corporations.* (i) Section 116 (b) and (c) contains further restrictions on the type of distributions which are treated as dividends for purposes of the exclusion. Thus, no exclusion is applicable with respect to dividends received from a corporation organized under the China Trade Act, 1922; from stock life insurance companies before January 1, 1959, in taxable years ending before such date; from corporations which during their taxable year of the distribution or their preceding taxable year were corporations to which section 931 applies (relating to income from sources within possessions of the United States); from corporations which during the taxable year of the distribution or the preceding taxable year are corporations exempt from tax either under section 501, relating to charitable, etc., organizations, or under section 521, relating to farmers' cooperative associations.

(ii) So-called dividends paid by mutual savings banks, cooperative banks, and building and loan associations which are allowed as a deduction under section 591 are ineligible for the exclusion.

(iii) For special rules as to the limitation on the amount of dividends for which an exclusion is allowable in the case of dividends paid by a regulated investment company, see section 854 and the regulations thereunder.

(iv) See section 857(c) and paragraph (d) of § 1.857-6 for special rules which deny an exclusion under section 116 in the case of dividends received from a real estate investment trust with respect to a taxable year for which such

trust is taxable under part II, subchapter M, chapter 1 of the Code.

(e) *Taxpayers not entitled to exclusion.* (1) For taxable years beginning after December 31, 1966, the exclusion allowed by section 116(a) and paragraph (a) of this section shall, in the case of a nonresident, alien individual, apply only (i) the determining the tax imposed for the taxable year pursuant to section 871(b)(1), and the regulations thereunder, and only in respect of dividends which are effectively connected for the taxable year with the conduct of a trade or business in the United States by such individual, or (ii) in determining the tax imposed for the taxable year pursuant to section 877(b). For taxable years beginning before January 1, 1967, the exclusion is not available to nonresident alien individuals with respect to whom a tax imposed for the taxable year under section 871(a).

(2) For additional rules for the treatment of dividends received by estates or trusts, and the allocation of such dividends between an estate or trust and the beneficiary thereof, see sections 652 and 662 and the regulations thereunder.

(3) For treatment of dividends received by a partnership, see section 702 and the regulations thereunder.

(4) For treatment of dividends received by a common trust fund, see section 584 and the regulations thereunder.

(f) *Time dividends are received.* In cases where it is necessary to determine the time of receipt of dividends the rules established to determine in which taxable year dividends must be included in gross income apply, including the rules relating to constructive receipt. See section 451 and regulations thereunder.

(g) *Special rule relating to receipt of dividends by beneficiary of an estate or trust.* In general, dividends are deemed received by a beneficiary in the taxable year in which they are includible in his gross income under section 652 or 662. However, solely for purposes of determining the amount of the exclusion applicable to dividends received by a beneficiary from an estate or trust, the time of receipt of such dividends by the estate or trust is also considered the time of receipt by the beneficiary.

[T.D. 6777, 29 FR 17807, Dec. 16, 1964, as amended by T.D. 7332, 39 FR 44216, Dec. 23, 1974; T.D. 7767, 46 FR 11263, Feb. 6, 1981]

§ 1.116–2 Effective date; taxable years ending after July 31, 1954, subject to the Internal Revenue Code of 1939.

Pursuant to section 7581(a)(1)(C), the regulations prescribed in § 1.116–1 shall also apply to taxable years beginning before January 1, 1954, and ending after July 31, 1954, and to taxable years beginning after December 31, 1953, and ending after July 31, 1954, but before August 17, 1954, though such years are subject to the Internal Revenue Code of 1939.

§ 1.117–1 Exclusion of amounts received as a scholarship or fellowship grant.

(a) *In general.* Any amount received by an individual as a scholarship at an educational institution or as a fellowship grant, including the value of contributed services and accommodations, shall be excluded from the gross income of the recipient, subject to the limitations set forth in section 117(b) and § 1.117–2. The exclusion from gross income of an amount which is a scholarship or fellowship grant is controlled solely by section 117. Accordingly, to the extent that a scholarship or a fellowship grant exceeds the limitations of section 117(b) and § 1.117–2, it is includible in the gross income of the recipient notwithstanding the provisions of section 102 relating to exclusion from gross income of gifts, or section 74(b) relating to exclusion from gross income of certain prizes and awards. For definitions, see § 1.117–3.

(b) *Exclusion of amounts received to cover expenses.* (1) Subject to the limitations provided in subparagraph (2) of this paragraph, any amount received by an individual to cover expenses for travel (including meals and lodging while traveling and an allowance for travel of the individual's family), research, clerical help, or equipment is excludable from gross income provided that such expenses are incident to a scholarship or fellowship grant which is excludable from gross income under section 117(a)(1).

If, however, only a portion of a scholarship or fellowship grant is excludable from gross income under section 117(a)(1) because of the part-time employment limitation contained in section 117(b)(1) or because of the expiration of the 36-month period described in section 117(b)(2)(B), only the amount received to cover expenses incident to such excludable portion is excludable from gross income. The requirement that these expenses be incident to the scholarship or the fellowship grant means that the expenses of travel, research, clerical help, or equipment must be incurred by the individual in order to effectuate the purpose for which the scholarship or the fellowship grant was awarded.

(2)(i) In the case of a scholarship or fellowship grant which is awarded after July 28, 1956, the exclusion provided under subparagraph (1) of this paragraph is not applicable unless the amount received by the individual is specifically designated to cover expenses for travel, research, clerical help, or equipment.

(ii) In the case of a scholarship or fellowship grant awarded before July 29, 1956, the exclusion provided under subparagraph (1) of this paragraph is not applicable unless the recipient establishes, by competent evidence, that the amount was received to cover expenses for travel, research, clerical help, or equipment, but such amount need not be specifically designated. The fact that the recipient actually incurred expenses for travel, research, clerical help, or equipment is not sufficient to establish that the amount was received to cover such expenses.

(iii) The exclusion provided under subparagraph (1) of this paragraph is applicable only to the extent that the amount received for travel, research, clerical help, or equipment is actually expended for such expenses by the recipient during the term of the scholarship or fellowship grant and within a reasonable time before and after such term.

(3) The portion of any amount received to cover the expenses described in subparagraph (1) of this paragraph which is not actually expended for such expenses within the exclusion period described in subparagraph (2) of this paragraph shall, if not returned to the grantor within this period, be included in the gross income of the recipient for the taxable year in which such exclusion period expires.

§ 1.117-2 Limitations.

(a) *Individuals who are candidates for degrees*—(1) *In general.* Under the limitations provided by section 117(b)(1) in the case of an individual who is a candidate for a degree at an educational institution, the exclusion from gross income shall not apply (except as otherwise provided in subparagraph (2) of this paragraph) to that portion of any amount received as payment for teaching, research, or other services in the nature of part-time employment required as a condition to receiving the scholarship or fellowship grant. Payments for such part-time employment shall be included in the gross income of the recipient in an amount determined by reference to the rate of compensation ordinarily paid for similar services performed by an individual who is not the recipient of a scholarship or a fellowship grant. A typical example of employment under this subparagraph is the case of an individual who is required, as a condition to receiving the scholarship or the fellowship grant, to perform part-time teaching services. A requirement that the individual shall furnish periodic reports to the grantor of the scholarship or the fellowship grant for the purpose of keeping the grantor informed as to the general progress of the individual shall not be deemed to constitute the performance of services in the nature of part-time employment.

(2) *Exception.* If teaching, research, or other services are required of all candidates (whether or not recipients of scholarships or fellowship grants) for a particular degree as a condition to receiving the degree, such teaching, research, or other services on the part of the recipient of a scholarship or fellowship grant who is a candidate for such degree shall not be regarded as part-time employment within the meaning of this paragraph. Thus, if all candidates for a particular education degree are required, as part of their

regular course of study or curriculum, to perform part-time practice teaching services, such services are not to be regarded as part-time employment within the meaning of this paragraph.

(b) *Individuals who are not candidates for degrees*—(1) *Conditions for exclusion.* In the case of an individual who is not a candidate for a degree at an educational institution, the exclusion from gross income of an amount received as a scholarship or a fellowship grant shall apply (to the extent provided in subparagraph (2) of this paragraph) only if the grantor of the scholarship or fellowship grant is—

(i) An organization described in section 501(c)(3) which is exempt from tax under section 501(a),

(ii) The United States or an instrumentality or agency thereof, or a State, a territory, or a possession of the United States, or any political subdivision thereof, or the District of Columbia, or

(iii) For taxable years beginning after December 31, 1961, a foreign government, an international organization, or a binational or multinational educational and cultural foundation or commission created or continued pursuant to section 103 of the Mutual Educational and Cultural Exchange Act of 1961 (22 U.S.C. 2453).

(2) *Extent of exclusion.* (i) In the case of an individual who is not a candidate for a degree, the amount received as a scholarship or a fellowship grant which is excludable from gross income under section 117(a)(1) shall not exceed an amount equal to $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during the taxable year. In determining the number of months during the period for which the recipient received amounts under a scholarship or fellowship grant, computation shall be made on the basis of whole calendar months. A whole calendar month means a period of time terminating with the day of the succeeding month numerically corresponding to the day of the month of its beginning, less one, except that if there be no corresponding day of the succeeding month the period terminates with the last day of the succeeding month. For purposes of this computation a fractional part of a calendar month consisting of a period of time including 15 days or more shall be considered to be a whole calendar month and a fractional part of a calendar month consisting of a period of time including 14 days or less shall be disregarded. For example, if an individual receives a fellowship grant on September 13 which is to expire on June 12 of the following year, the grant shall be considered to have extended for a period of 9 months. If in the preceding example the grant expired on June 27, instead of June 12, the grant shall be considered to have extended for a period of 10 months.

(ii) No exclusion shall be allowed under section 117(a)(1) to an individual who is not a candidate for a degree after the recipient has, as an individual who is not a candidate for a degree, been entitled to an exclusion under that section for a period of 36 months. This limitation applies if the individual has received any amount which was either excluded or excludable from his gross income under section 117(a)(1) for any prior 36 months, whether or not consecutive. For example, if the individual received a fellowship grant of $7,200 for 3 years (which he elected to receive in 36 monthly installments of $200), his exclusion period would be exhausted even though he did not in any of the 36 months make use of the maximum exclusion. Accordingly, such individual would be entitled to no further exclusion from gross income with respect to any additional grants which he may receive as an individual who is not a candidate for a degree.

(iii) If an individual who is not a candidate for a degree receives amounts from more than one scholarship or fellowship grant during the taxable year, the total amounts received in the taxable year shall be aggregated for the purpose of computing the amount which may be excludable from gross income for such taxable year. If amounts are received from more than one scholarship or fellowship grant during the same month or months within the taxable year, such month or months shall be counted only once for the purpose of determining the number of months for which the individual received such amounts under

the scholarships or fellowship grants during the taxable year. For example, if an individual receives a fellowship grant from one source for the months of January to June of the taxable year and also receives a fellowship grant from another source for the months of March through December of the same taxable year, he shall be considered to have received amounts for 12 months of the taxable year. See example (4) in subparagraph (3) of this paragraph for further illustration.

(3) *Examples.* The application of this paragraph may be further illustrated by the following examples, it being assumed that in each example the grantor is a grantor who is described in section 117(b)(2)(A) and subparagraph (1) of this paragraph:

Example (1). B, an individual who files his return on the calendar year basis, is awarded a post-doctorate fellowship grant in March 1955. The grant is to commence on September 1, 1955, and is to end on May 31, 1956, so that it will extend over a period of 9 months. The amount of the fellowship grant is $4,500 and B receives this amount in monthly installments of $500 on the first day of each month commencing September 1, 1955. During the taxable year 1955, B receives a total of $2,000 with respect to the 4-month period September through December, inclusive. He may exclude $1,200 from gross income in the taxable year 1955 ($300×4) and must include the remaining $800 in gross income for that year. For the year 1956, he will exclude $1,500 ($300×5) from gross income with respect to the $2,500 which he receives in that year and must include in gross income $1,000.

Example (2). Assume the same facts as in example (1) except that B receives the full amount of the grant ($4,500) on September 1, 1955. Since the amount received in the taxable year 1955 is for the full term of the fellowship grant (9 months), B may exclude $2,700 ($300×9) from gross income for the taxable year 1955. The remaining $1,800 must be included in gross income for that year.

Example (3). C, an individual who files his return on the calendar year basis, is awarded a post-doctorate fellowship grant in March 1955. The amount of the grant is $4,500 for a period commencing on September 1, 1955, and ending 24 months thereafter. C receives the full amount of the grant on September 1, 1955. C may exclude from gross income for the taxable year 1955, the full amount of the grant ($4,500) since this amount does not exceed an amount equal to $300 times the number of months (24) for which he received the amount of the grant during that taxable year.

Example (4). (i) F, an individual who files his return on the calendar year basis, is awarded a post-doctorate fellowship grant (Grant A) for two years commencing June 1, 1955, in the amount of $4,800. He elects to receive his grant in monthly installments of $200 commencing June 1, 1955. On March 1, 1956, F is awarded another post-doctorate fellowship grant (Grant B) for two years commencing September 1, 1956, in the amount of $7,200. He elects to receive this grant in monthly installments of $300 commencing September 1, 1956.

(ii) For the calendar year 1955, F receives $1,400 from Grant A which he is entitled to exclude from gross income since it does not exceed an amount equal to $300 times the number of months (7) for which he received amounts under the grant in the taxable year.

(iii) For the calendar year 1956, F receives $3,600 as the aggregate of amounts received under fellowship grants ($2,400 from Grant A and $1,200 from Grant B). F will be entitled to exclude the entire amount of $3,600 from gross income for the calendar year 1956 since such amount does not exceed an amount equal to $300 times the number of months (12) for which he received amounts under the grants in the taxable year.

(iv) For the calendar year 1957, F receives $4,600 as the aggregate of amounts received under fellowship grants ($1,000 from Grant A and $3,600 from Grant B). F will be entitled to exclude $3,600 ($300×12) from gross income for the calendar year 1957 and he will have to include $1,000 in gross income.

(v) For the calendar year 1958, F receives $2,400 from Grant B. F is entitled to exclude $1,500 ($300×5) from gross income for the calendar year 1958 and he will have to include $900 in gross income. While F receives amounts under fellowship Grant B for 8 months during the calendar year 1958, he is limited to an amount equal to $300 times 5 (months) because of the fact that he has already been entitled to exclude (and has in fact excluded) amounts received as a fellowship grant for a period of 31 months. Accordingly, he can only exclude amounts received under the fellowship grant for 5 months during the calendar year 1958, because of the 36-month limitation period. The fact that he was entitled to exclude only $1,400 ($200 a month for 7 months) instead of the maximum amount of $2,100 ($300×7) in 1955, is immaterial and the limitation period of 36 months is applicable.

(vi) The following chart illustrates the computation of the number of months for which F received amounts under the fellowship grants during the respective taxable years and the computation of the total

amounts received under the fellowship grants during each taxable year:

Period for which received and source	Number of months	Amounts received
1955:		
June 1 to December 31	7	
Grant A		$1,400
Grant B		None
Aggregate	7	1,400
1956:		
January 1 to August 31	8	
Grant A		1,600
Grant B		None
September 1 to December 31	4	
Grant A		800
Grant B		1,200
Aggregate	12	3,600
1957:		
January 1 to May 31	5	
Grant A		1,000
Grant B		1,500
June 1 to December 31	7	
Grant A		None
Grant B		2,100
Aggregate	12	4,600
1958:		
January 1 to August 31	8	
Grant A		None
Grant B		2,400
Aggregate		2,400

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6782, 29 FR 18355, Dec. 24, 1964]

§ 1.117-3 Definitions.

(a) *Scholarship.* A scholarship generally means an amount paid or allowed to, or for the benefit of, a student, whether an undergraduate or a graduate, to aid such individual in pursuing his studies. The term includes the value of contributed services and accommodations (see paragraph (d) of this section) and the amount of tuition, matriculation, and other fees which are furnished or remitted to a student to aid him in pursuing his studies. The term also includes any amount received in the nature of a family allowance as a part of a scholarship. However, the term does not include any amount provided by an individual to aid a relative, friend, or other individual in pursuing his studies where the grantor is motivated by family or philanthropic considerations. If an educational institution maintains or participates in a plan whereby the tuition of a child of a faculty member of such institution is remitted by any other participating educational institution attended by such child, the amount of the tuition so remitted shall be considered to be an amount received as a scholarship.

(b) *Educational institution.* For definition of "educational institution" section 117 adopts the definition of that term which is prescribed in section 151(e)(4). Accordingly, for purposes of section 117 the term "educational institution" means only an educational institution which normally maintains a regular faculty and curriculum and normally has a regularly organized body of students in attendance at the place where its educational activities are carried on. See section 151(e)(4) and regulations thereunder.

(c) *Fellowship grant.* A fellowship grant generally means an amount paid or allowed to, or for the benefit of, an individual to aid him in the pursuit of study or research. The term includes the value of contributed services and accommodations (see paragraph (d) of this section) and the amount of tuition, matriculation, and other fees which are furnished or remitted to an individual to aid him in the pursuit of study or research. The term also includes any amount received in the nature of a family allowance as a part of a fellowship grant. However, the term does not include any amount provided by an individual to aid a relative, friend, or other individual in the pursuit of study or research where the grantor is motivated by family or philanthropic considerations.

(d) *Contributed services and accommodations.* The term "contributed services and accommodations" means such services and accommodations as room, board, laundry service, and similar services or accommodations which are received by an individual as a part of a scholarship or fellowship grant.

(e) *Candidate for a degree.* The term "candidate for a degree" means an individual, whether an undergraduate or a graduate, who is pursuing studies or conducting research to meet the requirements for an academic or professional degree conferred by colleges or universities. It is not essential that such study or research be pursued or conducted at an educational institu-

tion which confers such degrees if the purpose thereof is to meet the requirements for a degree of a college or university which does confer such degrees. A student who receives a scholarship for study at a secondary school or other educational institution is considered to be a "candidate for a degree."

§ 1.117–4 Items not considered as scholarships or fellowship grants.

The following payments or allowances shall not be considered to be amounts received as a scholarship or a fellowship grant for the purpose of section 117:

(a) *Educational and training allowances to veterans.* Educational and training allowances to a veteran pursuant to section 400 of the Servicemen's Readjustment Act of 1944 (58 Stat. 287) or pursuant to 38 U.S.C. 1631 (formerly section 231 of the Veterans' Readjustment Assistance Act of 1952).

(b) *Allowances to members of the Armed Forces of the United States.* Tuition and subsistence allowances to members of the Armed Forces of the United States who are students at an educational institution operated by the United States or approved by the United States for their education and training, such as the United States Naval Academy and the United States Military Academy.

(c) *Amounts paid as compensation for services or primarily for the benefit of the grantor.* (1) Except as provided in paragraph (a) of § 1.117–2, any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research, if such amount represents either compensation for past, present, or future employment services or represents payment for services which are subject to the direction or supervision of the grantor.

(2) Any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research primarily for the benefit of the grantor.

However, amounts paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research are considered to be amounts received as a scholarship or fellowship grant for the purpose of section 117 if the primary purpose of the studies or research is to further the education and training of the recipient in his individual capacity and the amount provided by the grantor for such purpose does not represent compensation or payment for the services described in subparagraph (1) of this paragraph. Neither the fact that the recipient is required to furnish reports of his progress to the grantor, nor the fact that the results of his studies or research may be of some incidental benefits to the grantor shall, of itself, be considered to destroy the essential character of such amount as a scholarship or fellowship grant.

§ 1.118–1 Contributions to the capital of a corporation.

In the case of a corporation, section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. Section 118 also applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies

paid for the purpose of inducing the taxpayer to limit production. See section 362 for the basis of property acquired by a corporation through a contribution to its capital by its stockholders or by nonstockholders.

§ 1.119–1 Meals and lodging furnished for the convenience of the employer.

(a) *Meals*—(1) *In general.* The value of meals furnished to an employee by his employer shall be excluded from the employee's gross income if two tests are met: (i) The meals are furnished on the business premises of the employer, and (ii) the meals are furnished for the convenience of the employer. The question of whether meals are furnished for the convenience of the employer is one of fact to be determined by analysis of all the facts and circumstances in each case. If the tests described in subdivisions (i) and (ii) of this subparagraph are met, the exclusion shall apply irrespective of whether under an employment contract or a statute fixing the terms of employment such meals are furnished as compensation.

(2) *Meals furnished without a charge.* (i) Meals furnished by an employer without charge to the employee will be regarded as furnished for the convenience of the employer if such meals are furnished for a substantial noncompensatory business reason of the employer. If an employer furnishes meals as a means of providing additional compensation to his employee (and not for a substantial noncompensatory business reason of the employer), the meals so furnished will not be regarded as furnished for the convenience of the employer. Conversely, if the employer furnishes meals to his employee for a substantial noncompensatory business reason, the meals so furnished will be regarded as furnished for the convenience of the employer, even though such meals are also furnished for a compensatory reason. In determining the reason of an employer for furnishing meals, the mere declaration that meals are furnished for a noncompensatory business reason is not sufficient to prove that meals are furnished for the convenience of the employer, but such determination will be based upon an examination of all the surrounding facts and circumstances. In subdivision (ii) of this subparagraph, there are set forth some of the substantial noncompensatory business reasons which occur frequently and which justify the conclusion that meals furnished for such a reason are furnished for the convenience of the employer. In subdivision (iii) of this subparagraph, there are set forth some of the business reasons which are considered to be compensatory and which, in the absence of a substantial noncompensatory business reason, justify the conclusion that meals furnished for such a reason are not furnished for the convenience of the employer. Generally, meals furnished before or after the working hours of the employee will not be regarded as furnished for the convenience of the employer, but see subdivision (ii) (*d*) and (*f*) of this subparagraph for some exceptions to this general rule. Meals furnished on nonworking days do not qualify for the exclusion under section 119. If the employee is required to occupy living quarters on the business premises of his employer as a condition of his employment (as defined in paragraph (b) of this section), the exclusion applies to the value of any meal furnished without charge to the employee on such premises.

(ii) (*a*) Meals will be regarded as furnished for a substantial noncompensatory business reason of the employer when the meals are furnished to the employee during his working hours to have the employee available for emergency call during his meal period. In order to demonstrate that meals are furnished to the employee to have the employee available for emergency call during the meal period, it must be shown that emergencies have actually occurred, or can reasonably be expected to occur, in the employer's business which have resulted, or will result, in the employer calling on the employee to perform his job during his meal period.

(*b*) Meals will be regarded as furnished for a substantial noncompensatory business reason of the employer when the meals are furnished to the employee during his working hours because the employer's business is such

that the employee must be restricted to a short meal period, such as 30 or 45 minutes, and because the employee could not be expected to eat elsewhere in such a short meal period. For example, meals may qualify under this subdivision when the employer is engaged in a business in which the peak work load occurs during the normal lunch hours. However, meals cannot qualify under this subdivision (*b*) when the reason for restricting the time of the meal period is so that the employee can be let off earlier in the day.

(*c*) Meals will be regarded as furnished for a substantial noncompensatory business reason of the employer when the meals are furnished to the employee during his working hours because the employee could not otherwise secure proper meals within a reasonable meal period. For example, meals may qualify under this subdivision (*c*) when there are insufficient eating facilities in the vicinity of the employer's premises.

(*d*) A meal furnished to a restaurant employee or other food service employee for each meal period in which the employee works will be regarded as furnished for a substantial noncompensatory business reason of the employer, irrespective of whether the meal is furnished during, immediately before, or immediately after the working hours of the employee.

(*e*) If the employer furnishes meals to employees at a place of business and the reason for furnishing the meals to each of substantially all of the employees who are furnished the meals is a substantial noncompensatory business reason of the employer, the meals furnished to each other employee will also be regarded as furnished for a substantial noncompensatory business reason of the employer.

(*f*) If an employer would have furnished a meal to an employee during his working hours for a substantial noncompensatory business reason, a meal furnished to such an employee immediately after his working hours because his duties prevented him from obtaining a meal during his working hours will be regarded as furnished for a substantial noncompensatory business reason.

(iii) Meals will be regarded as furnished for a compensatory business reason of the employer when the meals are furnished to the employee to promote the morale or goodwill of the employee, or to attract prospective employees.

(3) *Meals furnished with a charge.* (i) If an employer provides meals which an employee may or may not purchase, the meals will not be regarded as furnished for the convenience of the employer. Thus, meals for which a charge is made by the employer will not be regarded as furnished for the convenience of the employer if the employee has a choice of accepting the meals and paying for them or of not paying for them and providing his meals in another manner.

(ii) If an employer furnishes an employee meals for which the employee is charged an unvarying amount (for example, by subtraction from his stated compensation) irrespective of whether he accepts the meals, the amount of such flat charge made by the employer for such meals is not, as such, part of the compensation includible in the gross income of the employee; whether the value of the meals so furnished is excludable under section 119 is determined by applying the rules of subparagraph (2) of this paragraph. If meals furnished for an unvarying amount are not furnished for the convenience of the employer in accordance with the rules of subparagraph (2) of this paragraph, the employee shall include in gross income the value of the meals regardless of whether the value exceeds or is less than the amount charged for such meals. In the absence of evidence to the contrary, the value of the meals may be deemed to be equal to the amount charged for them.

(b) *Lodging.* The value of lodging furnished to an employee by the employer shall be excluded from the employee's gross income if three tests are met:

(1) The lodging is furnished on the business premises of the employer,

(2) The lodging is furnished for the convenience of the employer, and

(3) The employee is required to accept such lodging as a condition of his employment.

The requirement of subparagraph (3) of this paragraph that the employee is required to accept such lodging as a condition of his employment means that he be required to accept the lodging in order to enable him properly to perform the duties of his employment. Lodging will be regarded as furnished to enable the employee properly to perform the duties of his employment when, for example, the lodging is furnished because the employee is required to be available for duty at all times or because the employee could not perform the services required of him unless he is furnished such lodging. If the tests described in subparagraphs (1), (2), and (3) of this paragraph are met, the exclusion shall apply irrespective of whether a charge is made, or whether, under an employment contract or statute fixing the terms of employment, such lodging is furnished as compensation. If the employer furnishes the employee lodging for which the employee is charged an unvarying amount irrespective of whether he accepts the lodging, the amount of the charge made by the employer for such lodging is not, as such, part of the compensation includible in the gross income of the employee; whether the value of the lodging is excludable from gross income under section 119 is determined by applying the other rules of this paragraph. If the tests described in subparagraph (1), (2), and (3) of this paragraph are not met, the employee shall include in gross income the value of the lodging regardless of whether it exceeds or is less than the amount charged. In the absence of evidence to the contrary, the value of the lodging may be deemed to be equal to the amount charged.

(c) *Rules.* (1) For purposes of this section, the term "business premises of the employer" generally means the place of employment of the employee. For example, meals and lodging furnished in the employer's home to a domestic servant would constitute meals and lodging furnished on the business premises of the employer. Similarly, meals furnished to cowhands while herding their employer's cattle on leased land would be regarded as furnished on the business premises of the employer.

(2) The exclusion provided by section 119 applies only to meals and lodging furnished in kind by an employer to his employee. If the employee has an option to receive additional compensation in lieu of meals or lodging in kind, the value of such meals and lodging is not excluded from gross income. However, the mere fact that an employee, at his option, may decline to accept meals tendered in kind will not of itself require inclusion of the value thereof in gross income. Cash allowances for meals or lodging received by an employee are includible in gross income to the extent that such allowances constitute compensation.

(d) *Examples.* The provisions of section 119 may be illustrated by the following examples:

Example (1). A waitress who works from 7 a.m. to 4 p.m. is furnished without charge two meals a work day. The employer encourages the waitress to have her breakfast on his business premises before starting work, but does not require her to have breakfast there. She is required, however, to have her lunch on such premises. Since the waitress is a food service employee and works during the normal breakfast and lunch periods, the waitress is permitted to exclude from her gross income both the value of the breakfast and the value of the lunch.

Example (2). The waitress in example (1) is allowed to have meals on the employer's premises without charge on her days off. The waitress is not permitted to exclude the value of such meals from her gross income.

Example (3). A bank teller who works from 9 a.m. to 5 p.m. is furnished his lunch without charge in a cafeteria which the bank maintains on its premises. The bank furnishes the teller such meals in order to limit his lunch period to 30 minutes since the bank's peak work load occurs during the normal lunch period. If the teller had to obtain his lunch elsewhere, it would take him considerably longer than 30 minutes for lunch, and the bank strictly enforces the 30-minute time limit. The bank teller may exclude from his gross income the value of such meals obtained in the bank cafeteria.

Example (4). Assume the same facts as in example (3), except that the bank charges the bank teller an unvarying rate per meal regardless of whether he eats in the cafeteria. The bank teller is not required to include in gross income such flat amount

charged as part of his compensation, and he is entitled to exclude from his gross income the value of the meals he receives for such flat charge.

Example (5). A Civil Service employee of a State is employed at an institution and is required by his employer to be available for duty at all times. The employer furnishes the employee with meals and lodging at the institution without charge. Under the applicable State statute, his meals and lodging are regarded as part of the employee's compensation. The employee would nevertheless be entitled to exclude the value of such meals and lodging from his gross income.

Example (6). An employee of an institution is given the choice of residing at the institution free of charge, or of residing elsewhere and receiving a cash allowance in addition to his regular salary. If he elects to reside at the institution, the value to the employee of the lodging furnished by the employer will be includible in the employee's gross income because his residence at the institution is not required in order for him to perform properly the duties of his employment.

Example (7). A construction worker is employed at a construction project at a remote job site in Alaska. Due to the inaccessibility of facilities for the employees who are working at the job site to obtain food and lodging and the prevailing weather conditions, the employer is required to furnish meals and lodging to the employee at the camp site in order to carry on the construction project. The employee is required to pay $40 a week for the meals and lodging. The weekly charge of $40 is not, as such, part of the compensation includible in the gross income of the employee, and under paragraphs (a) and (b) of this section the value of the meals and lodging is excludable from his gross income.

Example (8). A manufacturing company provides a cafeteria on its premises at which its employees can purchase their lunch. There is no other eating facility located near the company's premises, but the employee can furnish his own meal by bringing his lunch. The amount of compensation which any employee is required to include in gross income is not reduced by the amount charged for the meals, and the meals are not considered to be furnished for the convenience of the employer.

Example (9). A hospital maintains a cafeteria on its premises where all of its 230 employees may obtain a meal during their working hours. No charge is made for these meals. The hospital furnishes such meals in order to have each of 210 of the employees available for any emergencies that may occur, and it is shown that each such employee is at times called upon to perform services during his meal period. Although the hospital does not require such employees to remain on the premises during meal periods, they rarely leave the hospital during their meal period. Since the hospital furnishes meals to each of substantially all of its employees in order to have each of them available for emergency call during his meal period, all of the hospital employees who obtain their meals in the hospital cafeteria may exclude from their gross income the value of such meals.

[T.D. 6745, 29 FR 9380, July 9, 1964]

§ 1.120–1 Statutory subsistence allowance received by police.

(a) Section 120 excludes from the gross income of an individual employed as a police official by a State, Territory, or possession of the United States, by any of their political subdivisions, or by the District of Columbia, any amount received as a statutory subsistence allowance to the extent that such allowance does not exceed $5 per day. For purposes of this section, the term "statutory subsistence allowance" means an amount which is designated as a subsistence allowance under the laws of a State, a Territory, or a possession of the United States, any political subdivision of any of the foregoing, or the District of Columbia and which is paid to an individual who is employed as a police official of such governmental unit. A subsistence allowance paid to a police official by any of the foregoing governmental units which is not so provided by statute may not be excluded from gross income under the provisions of section 120. The term "police official" includes an employee of any of the foregoing governmental units who has police duties, such as a sheriff, a detective, a policeman, or a State police trooper, however designated.

(b) The exclusion provided by section 120 is to be computed on a daily basis, that is, for each day for which the statutory allowance is paid. If the statute providing the allowance does not specify the daily amount of such allowance, the allowance shall be converted to a daily basis for the purpose of applying the limitation provided herein. For example, if a State statute provides for a weekly subsistence allowance, the daily amount is to be determined by dividing the weekly amount by the number of days for

which the allowance is paid. Thus, if a State trooper receives a weekly statutory subsistence allowance of $40 would be $8, that is, $40 divided by 5 for 5 days of the week, the daily amount would be $8, that is, $40 divided by 5. However, for purposes of this section, only $5 per day may be excluded, or $25 on a weekly basis.

(c) Expenses in respect of which the allowance under section 120 is paid may not be deducted under any provision of the income tax laws except to the extent that (1) such expenses exceed the amount of the exclusion, and (2) the excess is otherwise allowable as a deduction. For example, if a State statute provides a subsistence allowance of $3 per day and the taxpayer, a state trooper, incurs expenditures of $4.50 for meals while away from home overnight on official police duties only $3 would be excludable under this section. Expenses relating to such exclusion ($3) may not be deducted under any provision of the income tax laws. However, the remaining $1.50 may be an allowable deduction under section 162 as traveling expenses while away from home in the performanceof official duties. See § 1.162–2.

(d) In the case of taxable years ending after September 30, 1958, section 120 and this section do not apply to amounts received as a statutory subsistence allowance for any day after September 30, 1958.

§ 1.120–3 Notice of application for recognition of status of qualified group legal services plan.

(a) *In general.* In order for a plan to be a qualified group legal services plan for purposes of the exclusion from gross income provided by section 120(a), the plan must give notice to the Internal Revenue Service that it is applying for recognition of its status as a qualified plan. Paragraph (b) of this section describes how the notice is to be filed for the plan. Paragraph (c) of this section describes the action that the Internal Revenue Service will take in response to the notice submitted for the plan. Paragraph (d) of this section describes the period of plan qualification.

(b) *Filing of notice*—(1) *In general.* A notice of application for recognition of the status of a qualified group legal services plan must be filed with the key district director of internal revenue as described in § 601.201(n). The notice must be filed on Form 1024, Application for Recognition of Exemption Under section 501(a) or for Determination Under section 120, with the accompanying Schedule L, and must contain the information required by the form and any accompanying instructions. The form may be filed by either the employer adopting the plan or the person administering the plan. No Form 1024 and Schedule L may be filed for a plan before an employer adopts the plan, or proposes to adopt the plan contingent only upon the recognition of the plan as a qualified plan.

(2) *Plans to which more than one employer contributes.* In general, for purposes of section 120 the adoption of a plan by an employer constitutes the adoption of a separate plan to which that employer alone contributes, notwithstanding that, in form, the employer purports to adopt a plan with respect to which the employer is one of two or more contributing employers. Accordingly, a separate Schedule L must be filed pursuant to the instructions accompanying Form 1024 for each employer adopting a plan.

(3) *Certain collectively bargained plans.* Notwithstanding subparagraph (2) of this paragraph, if a plan to which more than one employer contributes is a plan to which this subparagraph (3) applies, the plan is treated as a single plan for purposes of section 120. Accordingly, only one Form 1024 and Schedule L is required to be filed for the plan, regardless of the number of employers originally adopting the plan. In addition, once a Form 1024 and Schedule L is filed, no additional filing is required with respect to an employer who thereafter adopts the plan. In general, this subparagraph (3) applies to any plan that is maintained pursuant to a collective bargaining agreement between employee representatives and more than one employer who is required by the plan instrument or other agreement to contribute to the plan with respect to employees (or their spouses or dependents) participating in the plan. This subpara-

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graph does not apply, however, if all employers required to contribute to the plan are corporations which are members of a controlled group of corporations within the meaning of section 1563(a), determined without regard to section 1563(e)(3)(C). If all employers required to contribute to the plan are corporations which are members of such a controlled group, the filing requirements described in subparagraph (2) of this paragraph apply, notwithstanding that the plan is maintained pursuant to a collective bargaining agreement.

(c) *Internal Revenue Service action on notice of application for recognition.* The Internal Revenue Service will issue to the person submitting Form 1024 and Schedule L a ruling or determination letter stating that the plan is or is not a qualified group legal services plan. For general procedural rules, see § 601.201 (a) through (n), as that section relates to rulings and determination letters.

(d) *Period of plan qualification*—(1) *In general.* In the case of a favorable determination, the plan will be considered a qualified group legal services plan. If a Form 1024 and Schedule L required to be filed by or on behalf of an employer is filed before—

(i) The end of the first plan year (as determined under the plan),

(ii) The end of the plan year within which the employer adopts the plan, or

(iii) July 29, 1980,

the period of plan qualification with respect to the employer will begin on the date the plan is adopted by the employer (or, if later, January 1, 1977). If the form and schedule are not filed before the latest of the dates described in subdivisions (i), (ii) and (iii), the period of plan qualification with respect to the employer will begin on the date of filing. In any case in which either the Form 1024 or Schedule L filed by or on behalf of an employer is incomplete, the date of filing is the date on which the incomplete form or schedule is filed, if the necessary additional information is provided at the request of the Commissioner within the additional time period allowed by the Commissioner. If the additional information is not provided within the additional time period, allowed, the date of filing is the date on which the additional information is filed. If no separate Form 1024 and Schedule L are required to be filed by or on behalf of an employer (see paragraph (b)(3) of this section), the period of plan qualification with respect to the employer will begin on the date the plan is adopted by the employer (or, if later, January 1, 1977). In any case in which a plan is materially modified to conform to the requirments of section 120, either before or after a Form 1024 and Schedule L are filed, the period of plan qualification will not include any period before the effective date of the modification.

(2) *Plans in existence on June 4, 1976.* (i) Notwithstanding paragraph (d)(1) of this section, a written group legal services plan providing for employer contributions which was in existence on June 4, 1976, will be considered a qualified group legal services plan for the period January 1, 1977, through April 2, 1977. However, if the plan is maintained pursuant to one or more agreements which were in effect on October 4, 1976, and which the Secretary of Labor finds to be collective bargaining agreements, the period of deemed qualification will extend beyond April 2, 1977, and end on the date on which the last of the collective bargaining agreements relating to the plan terminates. Extensions of a bargaining agreement which are agreed to after October 4, 1976, are to be disregarded. The period of deemed qualification for a plan maintained pursuant to a collective bargaining agreement will not, however, extend beyond December 31, 1981.

(ii) A written group legal services plan will be considered to have been in existence on June 4, 1976, if on or before that date the plan was reduced to writing and adopted by one or more employers. No amounts need have been contributed under the plan as of June 4, 1976.

(iii) Notwithstanding that a plan is a qualified plan for the period of deemed qualification described in this paragraph (d)(2), the rules of paragraphs (c) and (d)(1) of this section still apply with respect to a Form 1024 and Schedule L filed for the plan. For

example, if a Form 1024 and Schedule L filed by or on behalf of an employer are filed before the latest of the 3 dates described in paragraph (d)(1) of this section, in the case of a favorable determination the plan will be a qualified plan from the date the plan is adopted by the employer (or, if later, January 1, 1977), and any period of deemed qualification and the period of qualification based upon the favorable determination will overlap. However, in the case of a plan to which this paragraph (d)(2) applies, if a Form 1024 and Schedule L required to be filed by or on behalf of an employer is not filed before the latest of the 3 dates described in paragraph (d)(1) of this section, the following rules shall apply. In general, if Form 1024 and Schedule L are filed before the end of the plan year following the plan year with or within which the plan's period of deemed qualification expires, in the event of a favorable determination the plan will be a qualified plan with respect to the employer beginning on the earlier of the day following the date on which the period of deemed qualification expires or the date on which the Form 1024 and Schedule L are filed. The period of plan qualification with respect to an employer cannot, however, include any period before the employer adopts the plan. If the Form 1024 and Schedule L are not filed before the end of the plan year following the plan year with or within which the plan's period of deemed qualification expires, in the case of a favorable determination the plan will be a qualified plan with respect to an employer from the later of the date of filing or adoption of the plan by the employer. The rules described in paragraph (d)(1) of this section relating to incomplete filings and plan modifications apply with respect to a filing described in this paragraph (d)(2).

(e) *Effective date.* This section is effective for notices of application for recognition of the status of a qualified group legal services plan filed after May 29, 1980.

(Secs. 120(c)(4) and 7805 of the Internal Revenue Code of 1954, 90 Stat. 1926, 68A Stat. 917; (26 U.S.C. 120(c)(4), 7805))

[T.D. 7696, 45 FR 28320, Apr. 29, 1980]

§ 1.121-1 Gain from sale or exchange of residence of individual who has attained age 55.

(a) *General rule.* Section 121(a) provides that a taxpayer may, under certain circumstances, elect to exclude from gross income gain realized on the sale or exchange of property which was the taxpayer's principal residence. Subject to the other provisions of section 121 and the regulations thereunder, the election may be made only if—

(1) The taxpayer attained the age of 55 before the date of the sale or exchange of the taxpayer's principal residence, and

(2) Except as provided in paragraph (b) of this section, during the 5-year period ending on the date of the sale or exchange of the property the taxpayer owned and used the property as the taxpayer's principal residence for periods aggregating 3 years or more.

(b) *Transitional rule.* In the case of a sale or exchange of a residence before July 26, 1981, a taxpayer who has attained age 65 on the date of such sale or exchange may elect to have this section applied by substituting "8-year period" for "5-year period" and "5 years" for "3 years" in paragraph (a) of this section and where appropriate in §§ 1.121-4 and 1.121-5.

(c) *Ownership and use.* The requirements of ownership and use for periods aggregating 3 years or more may be satisfied by establishing ownership and use for 36 full months (or 60 full months if the transitional rule is elected) or for 1,095 days (365×3) (or 1,825 days if the transitional rule is elected). In establishing whether a taxpayer has satisfied the requirement of three years of use, short temporary absences such as for vacation or other seasonal absence (although accompanied with rental of the residence) are counted as periods of use.

(d) *Examples.* The provisions of paragraph (a) are illustrated by the following examples:

Example (1). Taxpayer A owned and used his house as his principal residence since 1966. On January 1, 1980, when he is over 55, A retires and moves to another state with his wife. A leases his house from then until September 30, 1981, when he sells it. A

may make an election under section 121(a) with respect to any gain on such sale since he has owned and used the house as his principal residence for 3 years out of the 5 years preceding the sale.

Example (2). Taxpayer B purchased his house in 1971 when he was 65 and lived there with his wife. On July 1, 1977, he moved out and leased the house to a tenant. On September 15, 1979, he sold the house. Although he does not meet the use requirements of section 1.121-1(a), he may elect to use the transitional rule in section 1.121-1(b), since the sale was made before July 26, 1981. Because he owned and used the house as his principal residence for 5 out of the 8 years preceding the sale, under the transitional rule he may elect the section 121 exclusion.

Example (3). Taxpayer C lived with his son and daughter-in-law in a house owned by his son from 1973 through 1979. On January 1, 1980, he purchased this house and on July 31, 1982 , he sold it. Although B used the property as his principal residence for more than 3 years, he is not entitled to make an election under section 121(a) in respect of such sale since he did not own the residence for a period aggregating 3 years during the 5 year period ending on the date of the sale.

Example (4). Taxpayer D, a college professor, purchased and moved into a house on January 1, 1980. He used the house as his principal residence continuously to February 1, 1982, on which date he went abroad for a 1-year sabbatical leave. During a portion of the period of leave the property was unoccupied and it was leased during the balance of the period. On March 1, 1983, 1 month after returning from such leave, he sold the house. Since his leave is not considered to be a short temporary absence for purposes of section 121(a), the period of such leave may not be included in determining whether D used the house as his principal residence for periods aggregating 3 years during the 5 year period ending on the date of the sale. Thus, D is not entitled to make an election under section 121(a) since he did not use the residence for the requisite period.

Example (5). Assume the same facts as in example (1) except that during the three summers from 1977 through 1979, A left his residence for a 2-month vacation each year. Although, in the 5 year period preceding the date of sale, the total time spent away from his residence on such vacations (6 months) plus the time spent away from such residence from January 1, 1980, to September 30, 1981 (21 months) exceeds 2 years, he may make an election under section 121(a) since the 2-month vacations are counted as periods of use in determining whether A used the residence for the requisite period.

[T.D. 7614, 44 FR 24839, Apr. 27, 1979]

§ 1.121-2 Limitations.

(a) *Dollar limitation*—(1) Amount excludable. Under section 121(a), an individual may exclude form gross income up to $100,000 of gain from the sale of his or her principal residence ($50,000 in the case of a separate return by a married individual).

(2) *Example.* The provisions of this paragraph are illustrated by the following example:

Example. Assume that A sells his principal residence for $160,800, that the amount realized is $160,400 (selling price reduced by selling expenses, described in paragraph (b)(4)(i) of § 1.1034-1, of $400); and that A's gain realized from the sale is $107,900 (amount realized reduced by adjusted basis of $52,500). The portion of the gain which is taxable is $7,900 ($107,900)−($100,000). Thus $100,000 is the portion of the gain excludable from gross income pursuant to an election under section 121(a).

(b) *Application to only one sale or exchange.* (1) Except as provided in paragraph (c), a taxpayer may not make an election to exclude from gross income gain from the sale or exchange or a principal residence if there is in effect at the time the taxpayer wishes to make such election—

(i) An election made by the taxpayer, under section 121(a), in respect of any other sale or exchange of a residence, or

(ii) An election made by the taxpayer's spouse (such marital status to be determined at the time of the sale or exchange by the taxpayer, see paragraph (f) of § 1.121-5) under the provisions of section 121(a) in respect of any other sale or exchange of a residence (without regard to whether at the time of such sale or exchange such spouse was married to the taxpayer).

If the taxpayer and his spouse, before their marriage each owned and used a separate residence and if (after their marriage) both residences are sold, whether or not in a single transaction, an election under section 121(a) may be made with respect to a sale of either residence (but not with respect to both residences) if, at the time of sale, the age, ownership, and use requirements are met.

(2) The provisions of this paragraph are illustrated by the following examples:

Example (1). While A and B are married, A sells his separately owned residence and makes an election under section 121(a) in respect of such sale. Pursuant to the requirement of section 121(c), B joins in such election. Subsequently, A and B are divorced and B married C. While B and C are married, C sells his residence. C is not entitled to make an election under section 121(a) since an election by B, his spouse, is in effect. It does not matter that B obtained no personal benefit from her election

Example (2). The facts are the same as in example (1) except that after the sale of C's residence, A and B, pursuant to the provisions of paragraph (c) of § 1.121-4, revoke their election. B and C, subject to the other provisions of this section, may then make an election with respect to any gain realized on the sale of C's residence.

Example (3). The facts are the same as in example (1) except that C marries B after C sells his residence but before he makes an election under section 121(a) with respect to any gain realized on such sale. C, if there is not in effect an election made by him under section 121(a) with respect to a prior sale, may make an election with respect to his sale since B does not have to join with him in such election. (In the case of a sale of property jointly held by husband and wife, see paragraph (a) of § 1.121-5.)

(c) *Additional election if prior sale was made on or before July 26, 1978.* In the case of any sale or exchange after July 26, 1978, section 121 shall be applied by not taking into account any election made with respect to a sale or exchange on or before such date.

[T.D. 7614, 44 FR 24840, Apr. 27, 1979]

§ 1.121-3 Definitions.

(a) *Principal residence.* The term "principal residence" has the same meaning as in section 1034 (relating to sale or exchange of residence) and the regulations thereunder (see paragraph (c)(3) of § 1.1034-1).

(b) *Sale or exchange.* A "sale or exchange" of a residence includes the destruction, theft, seizure, requisition, or condemnation of such residence.

(c) *Gain realized.* The term "gain realized" has the same meaning as in paragraph (b)(5) of § 1.1034-1 (determined without regard to section 121(d)(7) and paragraph (g) of § 1.121-5).

[T.D. 7614, 44 FR 24840, Apr. 27, 1979]

§ 1.121-4 Election.

(a) *General rule.* A taxpayer may make an election under section 121(a) in respect of a particular sale (or may revoke any such election) at any time before the expiration of the period for making a claim for credit or refund of Federal income tax for the taxable year in which the sale or exchange occurred. A taxpayer who is married at the time of the sale or exchange—

(1) May not make an election under section 121(a) unless his spouse (at the time of the sale or exchange) joins him in such election, and

(2) May not revoke an election previously made by him unless his spouse (at the time of the sale or exchange) joins him in the revocation.

If the taxpayer's spouse dies after the sale or exchange but before the expiration of the time for making an election under this section (and an election was not made by the husband and wife), the deceased spouse's personal representative (administrator or executor, etc.) must join with the taxpayer in making an election. For purposes of making an election under section 121(a), if no personal representative of the deceased spouse has been appointed at or before the time of making the election, then the surviving spouse shall be considered the personal representative of such deceased spouse. Any election previously made by the taxpayer may be revoked only if the personal representative of the taxpayer's deceased spouse joins in such revocation.

(b) *Manner of making election.* The election under section 121(a) shall be made in a statement signed by the taxpayer and (where required) by his spouse and attached to the taxpayer's income tax return, when filed, for the taxable year during which the sale or exchange of his residence occurs. (See Form 2119 and the accompanying instructions). The statement shall indicate that the taxpayer elects to exclude from his gross income for such year so much of the gain realized on such sale or exchange as may be excluded under section 121. The statement shall also show—

(1) The adjusted basis of the residence as of the date of disposition;

(2) The date of its acquisition;

(3) The date of its disposition;

(4) The names and social security numbers of the owners of the residence as of the date of sale, the form of such ownership, and the age and marital status (as determined under paragraph (f) of § 1.121-5) of such owner or owners at the time of the sale;

(5) The duration of any absences (other than vacation or other seasonal absence) by such owner or owners during the 5 years (8 years under the transitional rule) preceding the sale; and

(6) Whether any such owner or owners have previously made an election under section 121(a), the date of such election, the taxable year with respect to which such election was made, the district director with whom such election was filed, and, if such election has been revoked, the date of such revocation.

(c) *Manner of revoking election.* The revocation of an election under section 121(a) shall be made by the taxpayer by filing a signed statement showing his name and social security number and indicating that the taxpayer revokes the election he made under section 121(a). The statement shall also show the taxable year of the taxpayer for which such election was made. The statement shall be signed by the taxpayer and (where required) by his spouse or their personal representatives and filed with the district director with whom the election was filed. In addition, if, at the time the statement is filed, the statutory period for assessment of a deficiency for the taxable year for which the election was made will expire within one year, then, the revocation is not effective unless the taxpayer also consents, in writing, that the statutory period for assessment of any deficiency (to the extent that such deficiency is attributable to the revocation of the election) shall not expire before the expiration of one year after the date the statement was filed with the district director. Such consent must be filed prior to the date of the expiration of the statutory period for assessment for the taxable year for which the election was made.

[T.D. 7614, 44 FR 24840, Apr. 27, 1979]

§ 1.121-5 Special rules.

(a) *Property held jointly by husband and wife.* (1) If—

(i) On the date of the sale or exchange of a residence, such residence is held by a husband and wife as joint tenants, tenants by the entirety, or community property,

(ii) A joint return under section 6013 is made by such husband and wife for the taxable year in which the residence is sold or exchanged, and

(iii) One spouse satisfies the age, ownership, and use requirements of section 121(a),

then both the husband and wife are treated as satisfying the age, ownership, and use requirements of section 121(a). Thus, if the above conditions exist and one spouse meets all the requirements of section 121(a), the other spouse will be treated as meeting all such requirements.

(2) The provisions of this paragraph are illustrated by the following example:

Example. On January 1, 1979, A and B while married, sell their jointly owned residence which they have owned and used as their prinicipal residence continuously since 1968. At the time of the sale, A is age 56 and B is age 54. If A and B file a joint return for the year of the sale, B will be considered to have satisfied the age, ownership and use requirements of section 121(a) since A has satisfied such requirements.

(b) *Property of deceased spouse.* (1) A taxpayer is treated as satisfying the ownership and use requirements of section 121(a)(2) with respect to property if—

(i) His spouse is deceased on the date of the sale or exchange of such property, and

(ii) Such deceased spouse, had, during the 5-year period ending on the date of the sale or exchange of the property, satisfied such ownership and use requirements with respect to such property.

This rule, however, has no application if the surviving spouse is married at the time of the sale or exchange of such property, or if an election made by the deceased spouse under section

121(a) is in effect with respect to any other sale or exchange.

(2) The provisions of this paragraph are illustrated by the following example:

Example. H and W become husband and wife on January 1, 1979. On and after such date they use as their principal residence property which H has owned and used as his principal residence since January 1, 1967. H dies on January 1, 1981, and W inherits the property and continues to use the property as her principal residence. W sells the property on August 31, 1981, at which time she is over 55 and not married. H, during the 5-year period ending on the date of the sale (September 1, 1976, through August 31, 1981), satisfied the 3-year use and ownership requirements of section 121(a)(2) with respect to such property. Accordingly, W may make an election under section 121(a).

(c) *Tenant-stockholder in cooperative housing corporation.* An individual who holds stock as a "tenant-stockholder" in a "cooperative housing corporation", as those terms are defined in section 216(b), may be eligible to make an election under section 121(a) in respect of the sale or exchange of such stock. In determining whether the taxpayer meets the requirements of section 121(a), the ownership requirements of such section are applied to the holding of such stock and the use requirements of such section are applied to the house or apartment which the individual was entitled to occupy because of such stock ownership.

(d) *Tacking of holding periods in the case of involuntary conversion.* If the basis of the property sold or exchanged is determined (in whole or in part) under subsection (b) of section 1033 (relating to basis of property acquired through involuntary conversion), then the holding and use by the taxpayer of the converted property shall be treated as holding and use by the taxpayer of the property sold or exchanged.

For the treatment of involuntary conversion as a "sale or exchange" see section 1.121-3(b).

(e) *Property used in part as principal residence.* (1) When a taxpayer can satisfy the ownership and use requirements of section 121(a)(2) only with respect to a portion of the property sold, then section 121 shall apply only with respect to so much of the gain from the sale or exchange of the property as is attributable to such portion. Thus, if the residence was used only partially for residential purposes, only that part of the gain allocable to the residential portion is not to be recognized under section 121(a).

(2) The provisions of this paragraph are illustrated by the following example:

Example. Taxpayer A, an attorney, uses a portion of the property constituting his principal residence as a law office for a period in excess of 2 years out of the 5 years preceding the sale of such residence. Accordingly, section 121 does not apply with respect to so much of the gain on the sale of the property as is allocable to the portion of the property used as a law office.

(f) *Determination of marital status.* Marital status is to be determined as of the date of the sale or exchange of the residence. An individual who on the date of the sale or exchange is legally separated from his spouse under a decree of divorce or of separate maintenance is not considered as married on such date.

(g) *Application of sections 1033 and 1034.* (1) In applying sections 1033 (relating to involuntary conversions) and 1034 (relating to sale or exchange of residence), the amount realized from the sale or exchange of property used as one's principal residence is treated as being the amount determined without regard to section 121, reduced by the amount of gain excluded from gross income pursuant to an election made under section 121(a). Thus, the amount which must be invested in a new residence in order to fully satisfy the nonrecognition provisions of section 1033 or 1034 is reduced by the amount of gain not included in the taxpayer's gross income because of an election made under section 121(a).

(2) The provisions of this paragraph are illustrated by the following examples:

Example (1). Taxpayer A sells his residence for $180,000, incurring $2,000 in fixing-up expenses described in section 1034(b)(2). He has a basis of $65,000 for the residence. Of his total gain of $115,000 ($180,000-$65,000), $100,000 is excluded from his gross income under this section.

He may still use the provisions of section 1034 to defer all or part of the remaining $15,000 of gain. To determine the adjusted sales price for purposes of section 1034, the amount realized (consideration received minus selling expenses, described in paragraph (b)(4)(i) of section 1.1034-1) is reduced by the sum of the fixing-up expenses (described in paragraph (b)(6) of section 1.1034-1) plus the amount excluded under section 121. Here, then, for purposes of section 1034, A's adjusted sales price is $78,000 (($180,000—$2,000)—$100,000)). If his new residence costs at least $78,000, all $15,000 of the remaining gain will be deferred. However, if he purchases a new residence for $72,000, then $6,000 ($78,000—$72,000) of his gain is currently taxable.

Example (2). Taxpayer B's residence has a basis of $65,000. She sells the residence for $115,000. If she makes an election under section 121(a), her gain of $50,000 is all excluded from gross income, and, accordingly, no portion of the realized gain remains to be deferred under section 1034.

(h) *Special rules applicable to certain reacquisitions of real property.* For special rules relating to a case where real property with respect to which an election under this section is in effect is reacquired by the seller in partial or full satisfaction of the indebtedness arising from the sale of such property and resold by him within 1 year after the date of such reacquisition, sec. § 1.1038-2.

[T.D. 7614, 44 FR 24841, Apr. 27, 1979]

§ 1.122-1 Applicable rules relating to certain reduced uniformed services retirement pay.

(a) *Rule applicable prior to January 1, 1966.* In the case of a member or former member of the uniformed services of the United States (as defined in 37 U.S.C. 101(3)) who has made an election under subchapter I of chapter 73 of title 10 of the United States Code (also referred to in this section as the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431)) to receive a reduced amount of retired or retainer pay, gross income shall include the amount of any reduction made in his retired or retainer pay before January 1, 1966, by reason of such election, unless such reduction, or portion thereof, is otherwise excluded from gross income under part III of subchapter B of chapter 1 of the Internal Revenue Code of 1954 or any other provision of law.

(b) *Rule applicable after December 31, 1965*—(1) In a case of a member or former member of the uniformed services of the United States (as defined in 37 U.S.C. 101(3)), gross income shall not include the amount of any reduction made in his or her retired or retainer pay after December 31, 1965, by reason of—

(i) An election made under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431), or

(ii) The provisions of subchapter II of chapter 73 of title 10 of the United States Code (also referred to in this section as the Survivor Benefit Plan (10 U.S.C. 1447)).

(2) (i) In a case where a member or former member of the uniformed services has, pursuant to the election described in paragraph (a) of this section, received before January 1, 1966, a reduced amount of retired or retainer pay, he shall, after December 31, 1965, exclude from gross income under section 122(b) and this subdivision all amounts received as uniformed services retired or retainer pay until there has been so excluded an amount of retired or retainer pay equal to the "consideration for the contract" (as described in subdivision (iii) of this subparagraph).

(ii) Upon the death of a member or former member of the uniformed services, where the "consideration for the contract" (as described in subdivision (iii) of this subparagraph) has not been excluded in whole or in part from gross income under section 122(b) and subdivision (i) of this subparagraph, the survivor of such member who is receiving an annuity under chapter 73 of title 10 of the United States Code shall, after December 31, 1965, exclude from gross income under section 72(o) and this subdivision such annuity payments received after December 31, 1965, until there has been so excluded annuity payments equalling the portion of the "consideration for the contract" not previously excluded under subdivision (i) of this subparagraph.

(iii) The term "consideration for the contract" as used in this subparagraph means—

(*a*) The total amount of the reductions, if any, before January 1, 1966, in retired or retainer pay by reason of an election under subchapter I of chapter 73 of title 10 of the United States Code, plus

(*b*) The total amount, if any, deposited by the serviceman at any time pursuant to the provisions of sections 1438 or 1452 (d) of title 10 of the United States Code, plus

(*c*) The total amount, if any, excludable from income under section 101(b)(2)(D) and paragraph (a)(2) of § 1.101-2 with respect to a survivor annuity provided by such retired or retainer pay, minus

(*d*) The total amount, if any, excluded from income before January 1, 1966, pursuant to the provisions of section 72 (b) and (d) with respect to a survivor annuity provided by such retired or retainer pay.

(iv) In determining whether there has been a recovery of the "consideration for the contract" under subdivision (i) of this subparagraph, the exclusion of retired pay from income after December 31, 1965, under sections 104(a)(4) and 105(d) shall not be considered as recovery of all or part of the "consideration for the contract."

(c) *Special rules.* In any of the following situations, the computation of the excludable portion of disability retired pay received by the member or former member of the uniformed services shall be governed by the following rules:

(1) An exclusion under section 122(a) and paragraph (b)(1) of this section is applicable only in the taxable year in which a reduction in retired pay is made under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431) or the Survivor Benefit Plan (10 U.S.C. 1447)

(2) Where the member or former member of the uniformed services is entitled to exclude the whole or a portion of his retired pay under the provisions of section 104(a)(4) or section 105(d) and under section 122(a) and paragraph (b)(1) of this section, the exclusion under section 122(a) and paragraph (b)(1) of this section shall be applied prior to the exclusions under sections 104(a)(4) and 105(d).

(3) Where the member or former member of the uniformed services waives a portion of his disability retired pay, or such retired pay reduced under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431),or the Survivor Benefit Plan (10 U.S.C. 1447) in favor of a nontaxable pension or compensation receivable under laws administered by the Veterans Administration (38 U.S.C. 3105), the waived amount of such disability retired pay, or reduced amount thereof, shall first be subtracted from any amounts which are excludable under the provisions of sections 104(a)(4) or 105(d) so as to reduce the amounts otherwise excludable under those sections.

(4) Where the member or former member of the uniformed services receives (before any forfeiture) disability retired pay (whether or not reduced under the Retired Serviceman's Family Protection Plan) or the Survivor Benefit Plan which is partially excludable under section 104(a)(4), and also forfeits a portion of such disability retired pay under the Dual Compensation Act of 1964 (5 U.S.C. 5531 or any former corresponding provision of law), the amount of the forfeiture under such Act shall be applied against disability retired pay (before any forfeiture) in the same proportion that the excludable portion of such pay under section 104(a)(4) bears to the total amount of such pay after subtraction of any reduction under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431) or the Survivor Benefit Plan (10 U.S.C. 1447).

(5) The exclusion provided by section 122(b) and paragraph (b)(2)(i) of this section shall be available with respect to repayments made upon removal from the temporary disability retired list even though such repayments were previously excluded from gross income under section 104(a)(4) or 105(d).

However, the exclusion permitted by the prior sentence will apply only to the extent the repaid amount has not been previously excluded under section 122(b) and paragraph (b)(2)(i) of this section.

(d) *Examples with respect to the Retired Serviceman's Family Protection Plan.* The rules discussed in this section relating to the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431) may be illustrated by the following examples:

Example (1). A, a member of the uniformed services, retires on January 1, 1963, and receives nondisability retired pay computed to be 60 percent of his active duty pay of $10,000 per year, or $6,000 per year, based upon 24 years of service. He elects, under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431), to provide his survivor with an annuity equal to one-fourth of his reduced retired pay. His retired pay of $6,000 is reduced by $600, to $5,400, in order to provide a survivor annuity of $1,350 per year or $112.50 per month. For 1963, 1964, and 1965, A must include in gross income the unreduced amount of retired pay, or $6,000. For 1966 and subsequent years, he may exclude under section 122(a) and paragraph (b)(1) of this section the $600 total annual reductions to provide the survivor annuity, and may, for 1966, further exclude from gross income under section 122(b) and paragraph (b)(2)(i) of this section the $1,800 "consideration for the contract" *i.e.*, the total reductions which were made in 1963, 1964, and 1965, to provide the survivor annuity. Accordingly, A will include $3,600 of retired pay in gross income for 1966 ($6,000 minus the sum of $600 and $1,800).

Example (2). Assume the facts in Example (1) except that A retires on disability resulting from active service and his disability is rated at 40 percent. The entire amount of disability retirement pay, prior to and including 1966, is excludable from gross income under sections 104(a)(4) and 105(d), and in 1966, section 122(a). Assume further that A attains retirement age on December 31, 1966, dies on January 1, 1967, and his widow then begins receiving a survivor annuity under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431). A's widow may exclude from gross income in 1967 and 1968 under section 72(o) and paragraph (b)(2)(ii) of this section, the $1,800 of "consideration for the contract" *i.e.*, the reductions in 1963, 1964, and 1965 to provide the survivor annuity. Thus, A's widow will exclude all of the survivor annuity she receives in 1967 ($1,350) and $450 of the $1,350 annuity received in 1968. In addition, if A had not attained retirement age at the time of his death, his widow would, under section 101 and paragraph (a)(2) of § 1.101-2, exclude up to $5,000 subject to the limitations of paragraph (b)(2)(ii) of this section.

Example (3). Assume, in the previous example, that A dies on January 1, 1965, and his widow then begins receiving a survivor annuity. Assume further that A's widow is entitled to exclude under section 72(b) $1,000 of the $1,350 she received in 1965. Under section 72(o) and paragraph (b)(2)(ii) of this section, A's widow for 1966 will exclude the $200 remaining consideration for the contract ($1,200−$1,000) and will include $1,150 of the survivor annuity in gross income.

Example (4). B, a member of the uniformed services, retires on January 1, 1966, after 32 years of active military service, and receives disability retirement pay under section 1401 of title 10, limited to 75 percent of his active duty pay of $15,000 per year, or $11,250. His disability rating is 30 percent. B has not reached retirement age (as defined in § 1.79-2(b)(3)). He elects under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431) to provide his survivor with an annuity equal to one-half of his reduced retired pay and, for that purpose, his retired pay of $11,250 is reduced by $1,250 to provide an annuity of $5,000 per year. B also elects to waive retired pay in the amount of $1,000 in order to receive disability compensation in like amount under laws administered by the Veterans Administration. In addition, B is required to forfeit $4,088 of his retired pay under the Dual Compensation Act of 1964 (5 U.S.C. 5532) ($11,250−$1,000=$10,250 less one-half of excess thereof over $2,074) and by reason of his Federal employment is not entitled to an exclusion of his retired pay under section 105(d). B's taxable retired pay for 1966 is $3,002, computed as follows:

Gross retired pay	$11,250
Less: Section 122(a) exclusion	(1,250)
Reduced retired pay	10,000
Less: Retired pay waived to receive V.A. compensation	(1,000)
Adjusted retired pay—	9,000
Less:	
(i) Excludable retired pay computed under section 104(a)(4) as limited by 10 U.S.C. 1403	$4,500
(ii) Less: Retired pay, not to exceed (i), waived to receive V.A. compensation	(1,000)
(iii) Net disability exclusion	(3,500)
Taxable retired pay before adjustment for Dual Compensation forfeiture	5,500
Less:	
Adjustment for Dual Compensation forfeiture of $4,088	
5500÷9000×$4,088=$2,498 (rounded)	(2,498)
Net taxable retired pay	3,002

Example (5). C, a member of the uniformed services retires on January 1, 1966, and receives disability retirement pay of $11,250 per year, which is reduced by $1,250 to provide a survivor annuity, and $1,000 of which is waived in order to receive disability compensation in like amount under laws ad-

ministered by the Veterans Administration. C has not reached retirement age for purposes of section 105(d) and is not employed by the Federal Government. C's taxable disability retirement pay for 1966 is $300 computed as follows:

Adjusted retired pay		$9,000
Less:		
(i) Excludable retired pay under section (a)(4) as limited by 10 U.S.C. 1403	$4,500	
(ii) Excludable retired pay under section 105(d)	5,200	
(iii) Total	9,700	
(iv) Less: Retired pay, not to exceed (iii), waived to receive V.A. compensation "sick pay" excludion	(1,000)	
(v) Net disability and "sick pay" exclusion		(8,700)
Net taxable retired pay		800

Example (6). D, a member of the uniformed services, retires for physical disability resulting from active service on January 1, 1966, after 35 years of service and with a disability rated at 20 percent. His active duty pay is $4,000 per year and he attained retirement age prior to retirement. He had an election in effect under the Retired Serviceman's Family Protection Plan to provide his survivor with an annuity and his retired pay is reduced therefor by $500 per year. He waives $1,300 of his retired pay in order to receive compensation from the Veterans Administration in like amount. His taxable retired pay for 1966 is $1,200 computed as follows:

Gross retired pay (75% × $4,000		$3,000
Less: Section 122(a) exclusion		(500)
Reduced retired pay		2,500
Less: V.A. waiver		(1,300)
Adjusted retired pay		1,200
Less:		
(i) Section 104(a)(4) exclusion	$800	
(ii) Less: Retired pay, not to exceed (i), waived to receive V.A. compensation	(800)	
(iii) Net disability exclusion	0	
Net taxable retired pay		1,200

(e) *Principles applicable to the Survivor Benefit Plan.* The principles illustrated by the examples set forth in paragraph (d) of this section apply to an annuity under the Survivor Benefit Plan (10 U.S.C. 1447).

[T.D. 7043, 35 FR 8478, June 2, 1970, as amended by T.D. 7562, 43 FR 38819, Aug. 31, 1978]

§ 1.123–1 Exclusion of insurance proceeds for reimbursement of certain living expenses.

(a) *In general.* (1) Gross income does not include insurance proceeds received by an individual on or after January 1, 1969, pursuant to the terms of an insurance contract for indemnification of the temporary increase in living expenses resulting from the loss of use or occupancy of his principal residence, or a part thereof, due to damage or destruction by fire, storm, or other casualty. The term "other casualty" has the same meaning assigned to such term under section 165(c)(3). The exclusion also applies in the case of an individual who is denied access to his principal residence by governmental authorities because of the occurrence (or threat of occurrence) of such a casualty. The amount excludable under this section is subject to the limitation set forth in paragraph (b) of this section.

(2) This exclusion applies to amounts received as reimbursement or compensation for the reasonable and necessary increase in living expenses incurred by the insured and members of his household to maintain their customary standard of living during the loss period.

(3) This exclusion does not apply to an insurance recovery for the loss of rental income. Nor does the exclusion apply to any insurance recovery which compensates for the loss of, or damage to, real or personal property. See section 165(c)(3) relating to casualty losses; section 1231 relating to gain on an involuntary conversion of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977); and section 1033 relating to recognition of gain on an involuntary conversion. In the case of property used by an insured partially as a principal residence and partially for other purposes, the exclusion does not apply to the amount of insurance proceeds which compensates for the portion of increased expenses attributable to the nonresidential use of temporary replacement property during the loss period. In the case of denial of access to a principal resi-

dence by governmental authority, the exclusion provided by this section does not apply to an insurance recovery received by an individual as reimbursement for living expenses incurred by reason of a governmental condemnation or order not related to a casualty or the threat of a casualty.

(4) (i) Subject to the limitation set forth in paragraph (b), the amount excludable is the amount which is identified by the insurer as being paid exclusively for increased living expenses resulting from the loss of use or occupancy of the principal residence and pursuant to the terms of the insurance contract.

(ii) When a lump-sum insurance settlement includes, but does not specifically identify, compensation for property damage, loss of rental income, and increased living expenses, the amount of such settlement allocable to living expenses shall, in the case of uncontested claims, be that portion of the settlement which bears the same ratio to the total recovery as the amount of claimed increased living expense bears to the total amount of claimed losses and expenses, to the extent not in excess of the coverage limitations specified in the contract for such losses and expenses.

(iii) In the case of a lump-sum settlement involving contested claims, the insured shall establish the amount reasonably allocable to increased living expenses, consistent with the terms of the contract and other facts of the particular case.

(iv) In no event may the amount of a lump-sum settlement which is allocable to increased living expenses exceed the coverage limitation specified in the contract for increased living expenses. Where, however, a coverage limitation is applicable to the total amount payable for increased living expenses and, for example, loss of rental income, the amount of an unitemized settlement which is allocable to increased living expenses may not exceed the portion of the applicable coverage limitation which bears the same ratio to such limitation as the amount of increased living expenses bears to the sum of the amount of such increased living expenses and the amount, if any, of lost rental income.

(5) The portion of any insurance recovery for increased living expenses which exceeds the limitation set forth in paragraph (b) shall be included in gross income under section 61 of the Code.

(b) *Limitation*—(1) *Amount excludable.* The amount excludable under this section is limited to amounts received which are not in excess of the amount by which (i) total actual living expenses incurred by the insured and members of his household which result from the loss of use or occupancy of their residence exceed (ii) the total normal living expenses which would have been incurred during the loss period but are not incurred as a result of the loss of use or occupancy of the principal residence. Generally, the excludable amount represents such excess expenses actually incurred by reason of a casualty, or threat thereof, for renting suitable housing and for extraordinary expenses for transportation, food, utilities, and miscellaneous services during the period of repair or replacement of the damaged principal residence or denial of access by governmental authority.

(2) *Actual living expenses.* For purposes of this section, actual living expenses are the reasonable and necessary expenses incurred as a result of the loss of use or occupancy of the principal residence to maintain the insured and members of his household in accordance with their customary standard of living. Actual living expenses must be of such a nature as to qualify as a reimbursable expense under the terms of the applicable insurance contract without regard to monetary limitations upon coverage. Generally, actual living expenses include the cost during the loss period of temporary housing, utilities furnished at the place of temporary housing, meals obtained at restaurants which customarily would have been prepared in the residence, transportation, and other miscellaneous services. To the extent that the loss of use or occupancy of the principal residence results merely in an increase in the amount expended for items of living expenses normally incurred, such as food and transportation, only the increase in such costs shall be considered as

actual living expenses in computing the limitation.

(3) *Normal living expenses not incurred.* Normal living expenses consist of the same categories of expenses comprising actual living expenses which would have been incurred but are not incurred as a result of the casualty or threat thereof. If the loss of use of the residence results in a decrease in the amount normally expended for a living expense item during the loss period, the item of normal living expense is considered not to have been incurred to the extent of the decrease for purposes of computing the limitation.

(4) *Examples.* The application of this paragraph (b) may be illustrated by the following examples:

Example (1). On March 1, 1970, A's principal residence, a dwelling owned by A no part of which was rented to others or used for nonresidential purposes, was extensively damaged by fire. The damaged residence was under repair during the entire month of March making it necessary for A and his spouse to obtain temporary lodging and to take their meals at a restaurant. A and his spouse incur expenses of $200 for lodging at a motel, $180 for meals which customarily would have been prepared in his residence, and $25 for commercial laundry service which customarily would have been done by A's wife. A makes (directly or through mortgage insurance), or remains liable for, the required March payment of $190 on the mortgage note on his residence. The mortgage payment results from a contractual obligation having no causal relationship to the occurrence of the casualty and is not considered as an actual living expense resulting from the loss of use of the residence. A's customary commuting expense of $40 for bus fares to and from work is decreased by $20 for the month because of the motel's closer proximity to his place of employment. Other transportation expenses remain stable. Since there has been a decrease in the amount of A's customary bus fares, normal transportation expenses are considered not to have been incurred to the extent of the decrease. Finally, A does not incur customary expenses of $150 for food obtained for home preparation, $75 for utilities expenses, and $10 for laundry cleansers. The limitation upon the excludable amount of an insurance recovery for excess living expenses is $150, computed as follows:

LIVING EXPENSES

	Actual resulting from casualty	Normal not incurred	Increase (decrease)
Housing	$200.00		$200.00
Utilities		$75.00	(75.00)
Meals	180.00	150.00	30.00
Transportation		20.00	(20.00)
Laundry	25.00	10.00	150.00
Total	405.00	255.00	150.00

Example (2). Assume the same facts as in example (1) except that the damaged residence is not owned by A but is rented to him for $100 per month and that the risk of loss is upon the lessor. Since A would not have incurred the normal rental of $100 for March, the excludable amount is limited to $50 ($150 as in previous example less $100 normal rent not incurred).

(c) *Principal residence.* Whether or not property is used by the insured taxpayer and members of his household as their principal residence depends upon all the facts and circumstances in each case. For purposes of this section, a principal residence may be a dwelling or an apartment leased to the insured as well as a dwelling or apartment owned by the insured.

[T.D. 7118, 36 FR 10729, June 2, 1971, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

STANDARD DEDUCTION FOR INDIVIDUALS

§ 1.141–1 Standard deduction.

(a) *In general.* The standard deduction referred to in this section is:

(1) For taxable years beginning before January 1, 1964, the 10-percent standard deduction,

(2) For taxable years beginning after December 31, 1963, and before January 1, 1970, the larger of the 10-percent standard deduction or the minimum standard deduction, and

(3) For taxable years beginning after December 31, 1969, the larger of the percentage standard deduction or the low income allowance.

The taxpayer may elect to take, in addition to the deductions from gross income allowable in computing adjusted gross income and the deduction described in section 151 relating to personal exemptions, a standard deduc-

tion in lieu of all deductions other than those described in section 62 and in lieu of certain credits allowable to the taxpayer, had he not so elected. See section 36. Such credits include: The credit provided by section 33 for taxes imposed by foreign countries and possessions of the United States; the credit provided by section 32 for tax withheld at source under section 1451 by the obligor on tax-free covenant bonds with respect to interest on such bonds; and the credit provided by section 35 with respect to interest on United States obligations and interest on obligations of instrumentalities of the United States. In the case of a taxable year beginning before January 1, 1970, such standard deduction, however, may in no event exceed $1,000, or $500 in the case of a separate return by a married individual. For determination of marital status see § 1.143-1. See section 4 and the regulations thereunder for rules relating to standard deduction in respect of optional tax. The optional tax tables provided for in section 3 reflect the standard deduction provided for in section 141.

(b) *Ten-percent standard deduction.* The 10-percent standard deduction is (except for the limitation in paragraph (a) of this section) an amount equal to 10 percent of the taxpayer's adjusted gross income. In the case of a joint return, there is only one adjusted gross income and only one 10-percent standard deduction. For example, if a husband has an income of $15,000 and his spouse has an income of $12,000 for the taxable year for which they file a joint return, and they have no deductions allowable for the purpose of computing adjusted gross income, the adjusted gross income is $27,000, and the 10-percent standard deduction is $1,000 (and not $2,000).

(c) *Minimum standard deduction.* The minimum standard deduction is (except for the limitation in paragraph (a) of this section) an amount equal to the sum of—

(1) $100, multiplied by the number of exemptions allowed for the taxable year as a deduction under section 151,

(2) In addition,

(i) $200, in the case of a joint return of a husband and wife under section 6013,

(ii) $200, in the case of a return of an individual who is not married, or

(iii) $100, in the case of a separate return of a married individual.

The return of a surviving spouse is treated as a joint return for purposes of subdivision (i) of this subparagraph. See section 2, and the regulations thereunder, with respect to the definition of a surviving spouse.

(d) *Percentage standard deduction.* The percentage standard deduction is an amount equal to the applicable percentage of adjusted gross income shown in the following table, but not to exceed the maximum amount shown in such table (or one-half of such maximum amount in the case of a separate return by a married individual):

Taxable years beginning in—	Applicable percentage	Maximum amount
1970	10	$1,000
1971	13	1,500
1972	14	2,000
1973 and thereafter	15	2,000

(e) *Low income allowance*—(1) *In general*—(i) *For taxable years beginning in 1970 and 1971.* For taxable years beginning after December 31, 1969, and before January 1, 1972, the low income allowance is an amount equal to the sum of the basic allowance and the additional allowance. The low income allowance is never less than the basic allowance. In the case of a married taxpayer (as determined by applying section 143(a), but not including an individual who is not considered as married, as determined by applying section 143(b)), filing a separate return, however, the low income allowance is equal to the basic allowance, and the basic allowance is an amount (not in excess of $500) equal to the sum of (*a*) $100, plus (*b*) $100, multiplied by the number of exemptions allowed as a deduction for the taxable year under section 151.

(ii) *For taxable years beginning after December 31, 1971.* For taxable years beginning after December 31, 1971, the low income allowance is $1,000 in the case of a return of an individual who is not married (including an indi-

vidual who is not considered as married by virtue of section 143(b)) or in the case of a joint return of a married couple. The low income allowance is $500 in the case of a married individual filing a separate return.

(2) *Basic allowance.* The basic allowance is an amount, not in excess of $1,000, equal to the sum of—

(i) $200, plus

(ii) $100, multiplied by the number of exemptions allowed as a deduction for the taxable year under section 151.

(3) *Additional allowance*—(i) *In general.* The additional allowance is an amount equal to the excess (if any) of $900 ($850, in the case of a taxable year beginning after December 31, 1970, and before January 1, 1972) over the sum of—

(*a*) $100, multiplied by the number of such exemptions, plus

(*b*) The income phase-out, if any.

(ii) *Income phase-out.* The income phase-out is an amount equal to one-half (one-fifteenth in the case of a taxable year beginning after December 31, 1970, and before January 1, 1972) of the amount (if any) by which the adjusted gross income for the taxable year exceeds the sum of—

(*a*) $1,100 ($1,050, in the case of a taxable year beginning after December 31, 1970, and before January 1, 1972), plus

(*b*) $625 ($650, in the case of a taxable year beginning after December 31, 1970, and before January 1, 1972) multiplied by the number of such exemptions.

(4) *Examples.* The application of this section may be illustrated by the following examples:

Example (1). H, a married individual, files a joint return with W, his wife, for calendar year 1970. Their combined adjusted gross income for that year is $5,000. They are entitled to six exemptions under section 151 for the year. Their standard deduction is the low income allowance ($1,025.00) since it is larger than the percentage standard deduction ($500) and is computed as follows:

Percentage standard deduction (10% of $5,000)			$500
Low income allowance:			
(i) Basic allowance ($200, plus $100 multiplied by the number of exemptions [6], but not in excess of $1,000)		$800	
Plus			
(ii) Additional allowance (Excess of $900 over the sum of $100 multiplied by the number of exemptions and the income phase-out):			
(*a*) $100 × number of exemptions (6)		$600	
Plus			
(*b*) Income phase-out:			
(*1*) Adjusted gross income	$5,000		
(*2*) Less ($1,100 + [625 × 6]	4,850		
	$150		
(*3*) Income phase-out (½ × 150)		$75	
(*c*) Additional allowance ($900 − [600 + 75])			$225
(iii) Low income allowance (basic allowance [$800] plus additional allowance [$225])			$1,025

Example (2). H, a married individual, files a joint return with W, his wife, for calendar year 1971. Their combined adjusted gross income for that year is $5,000. They are entitled to six exemptions under section 151 for the year. Their standard deduction is the low income allowance ($1,046.67) since it is larger than the percentage standard deduction ($650) and is computed as follows:

Percentage standard deduction (13% of $5,000)			$650.00
Low income allowance:			
(i) Basic allowance ($200, plus $100 multiplied by the number of exemptions [6], but not in excess of $1,000)		$800.00	
Plus			
(ii) Additional allowance (Excess of $850 over the sum of $100 multiplied by the number of exemptions and the income phase-out):			
(*a*) $100 × number of exemptions (6)		$600.00	
Plus			
(*b*) Income phase-out:			
(*1*) Adjusted gross income	$5,000.00		

(2) Less ($1,050 + [650 × 6])	4,950.00		
	$50.00		
(3) Income phase-out (1/15 × 50)		$3.33	
(c) Additional allowance ($850 − [600 + 3.33])			$246.67
(iii) Low income allowance (Basic allowance [$800] plus additional allowance [$246.67])			$1,046.67

Example (3). H, a married taxpayer living with his spouse, files a separate return for 1971 and has adjusted gross income of $3,000 for that year. He is entitled to six exemptions under section 151 for the year. H's standard deduction is the low income allowance which is equal to the basic allowance (not in excess of $500), and is computed as follows:

Percentage standard deduction ($3,000 × 13%)		$390
Low income allowance:		
Basic allowance ($100, plus $100 multiplied by number of exemptions [6] but not in excess of $500)	$500	
Low income allowance		$500

Example (4). H, a married individual entitled to six exemptions, files a separate return for 1971, is living apart from his spouse and qualifies under section 143(b) and paragraph (b) of § 1.143-1 to be considered as not married. H has adjusted gross income of $5,000. His standard deduction is the low income allowance ($1,046.67) and is computed in the manner shown in example (2).

(f) *Married individuals filing separate returns.* (1) In the case of a married individual filing a separate return for a taxable year beginning after December 31, 1969, the low income allowance shall not apply if the tax of the other spouse is determined with regard to the percentage standard deduction or is computed by the Internal Revenue Service pursuant to section 6014.

(2) A married individual filing a separate return for a taxable year beginning after December 31, 1969, may elect to determine his tax with regard to the low income allowance in lieu of determining it under the percentage standard deduction although his low income allowance is less than the percentage standard deduction if the low income allowance of his spouse is greater than the percentage standard deduction of such spouse. A taxpayer shall signify on his return his election to determine his tax with regard to the low income allowance by claiming thereon the deduction in the amount provided for in section 141(c) instead of the amount provided for in section 141(b).

(3) In the case of a taxable year beginning after December 31, 1963, and before January 1, 1970, subparagraphs (1) and (2) of this paragraph shall be applied by substituting "minimum standard deduction", "the 10-percent standard deduction", and "December 31, 1963, and before January 1, 1970" for "low income allowance", "percentage standard deduction", and "December 31, 1969", respectively.

(4) For rules relating to the election to pay the optional tax imposed by section 3 when married individuals file separate returns, see section 4(c) and the regulations thereunder.

(g) *Short taxable year due to death of taxpayer.* An election to take the standard deduction may be made for a taxable year which is less than 12 months on account of the death of the taxpayer.

(h) *Cross reference.* For the computation of the standard deduction for a fiscal year beginning in 1969, 1970, 1971, or 1972, see section 21(d) and the regulations thereunder.

[T.D. 6792, 30 FR 530, Jan. 15, 1965, as amended by T.D. 7123, 36 FR 11085, June 9, 1971]

§ 1.142-1 Husband and wife.

(a) In the case of husband and wife, if the tax of one spouse is determined under section 1 or 1201 on the basis of the taxable income computed without regard to the standard deduction, the other spouse may not elect to take the standard deduction. If a joint return is filed and election made thereon to take the standard deduction, such deduction shall, subject to the limitations of section 141 and the regulations thereunder, be determined by reference to the aggregate adjusted gross income of both spouses. The filing of either a separate or joint return on Form 1040A constitutes an

election to take the standard deduction and, if the adjusted gross income shown on the return is less than $10,000 ($5,000 for taxable years beginning before January 1, 1971) an election to pay the optional tax imposed by section 3. See the regulations under section 4 for rules relating to elections to pay the optional tax imposed by section 3.

(b) If each spouse files a separate individual income tax return (Form 1040 or 1040A), both spouses must elect to take the standard deduction or both spouses are denied the standard deduction. Thus, if one spouse files a return on Form 1040 and does not elect to take the standard deduction, the other spouse may not elect to take the standard deduction and, hence, may not file a return on Form 1040A. For example, if A and his wife B have adjusted gross incomes of $6,000 and $3,500, respectively, from wages subject to withholding and A files a return on Form 1040 and does not elect thereon to take the standard deduction, B may not file her return on Form 1040A, but must file on Form 1040 and compute her tax without regard to the standard deduction. In such case, however, if both elect to take the standard deduction either taxpayer may file on Form 1040 or 1040A, but B's tax must be computed on the basis of the applicable tax table in section 3. See § 1.4-3 for rules relating to the computation of the optional tax when a husband and wife file separate returns.

(c) The restriction upon the right of a married person to elect the standard deduction in his separate return is applicable with respect to the taxable years of the husband and wife ending in the same calendar year, except that in the event of the death of one spouse the restriction is applicable with respect to the taxable year ended with death and the taxable year of the surviving spouse in which such death occurs. The restriction applies unless the spouses are legally separated under a decree of divorce or separate maintenance. For determination of marital status, see § 1.143-1.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6792, 30 FR 531, Jan. 15, 1965; T.D. 7269, 38 FR 9295, Apr. 13, 1973]

§ 1.142-2 Standard deduction not allowable.

The standard deduction is not allowable in the case of—

(a) A nonresident alien individual (including one who enters and leaves the United States at frequent intervals);

(b) A citizen of the United States entitled to the benefits of section 931;

(c) A taxable year of less than 12 months where such taxable year arises because of a change in accounting period under section 443(a)(1); or

(d) An estate or trust, common trust fund, or partnership.

§ 1.143-1 Determination of marital status.

(a) *General rule.* The determination of whether an individual is married shall be made as of the close of his taxable year unless his spouse dies during his taxable year, in which case such determination shall be made as of the time of such death; and, except as provided in paragraph (b) of this section, an individual shall be considered as married even though living apart from his spouse unless legally separated under a decree of divorce or separate maintenance. The provisions of this paragraph may be illustrated by the following examples:

Example (1). Taxpayer A and his wife B both make their returns on a calendar year basis. In July 1954, they enter into a separation agreement and thereafter live apart, but no decree of divorce or separate maintenance is issued until March 1955. If A itemizes and claims his actual deductions on his return for the calendar year 1954, B may not elect the standard deduction on her return since B is considered as married to A (although permanently separated by agreement) on the last day of 1954.

Example (2). Taxpayer A makes his returns on the basis of a fiscal year ending June 30. His wife B makes her returns on the calendar year basis. A died in October 1954. In such case, since A and B were married as of the date of death, B may not elect the standard deduction for the calendar year 1954 if the income of A for the short taxable year ending with the date of his death is determined without regard to the standard deduction.

(b) *Certain married individuals living apart.* (1) For purposes of part IV of subchapter B of chapter 1 of the Code, an individual is not considered

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as married for taxable years beginning after December 31, 1969, if (i) such individual is married (within the meaning of paragraph (a) of this section) but files a separate return; (ii) such individual maintains as his home a household which constitutes for more than one-half of the taxable year the principal place of abode of a dependent (*a*) who (within the meaning of section 152 and the regulations thereunder) is a son, stepson, daughter, or stepdaughter of the individual, and (*b*) with respect to whom such individual is entitled to a deduction for the taxable year under section 151; (iii) such individual furnishes over half of the cost of maintaining such household during the taxable year; and (iv) during the entire taxable year such individual's spouse is not a member of such household.

(2) For purposes of subparagraph (1)(ii)(*a*) of this paragraph, a legally adopted son or daughter of an individual, a child (described in paragraph (c)(2) of § 1.152-2) who is a member of an individual's household if placed with such individual by an authorized placement agency (as defined in paragraph (c)(2) of § 1.152-2) for legal adoption by such individual, or a foster child (described in paragraph (c)(4) of § 1.152-2) of an individual if such child satisfies the requirements of section 152(a)(9) of the Code and paragraph (b) of § 1.152-1 with respect to such individual, shall be treated as a son or daughter of such individual by blood.

(3) For purposes of subparagraph (1)(ii) of this paragraph, the household must actually constitute the home of the individual for his taxable year. However, a physical change in the location of such home will not prevent an individual from qualifying for the treatment provided in subparagraph (1) of this paragraph. It is not sufficient that the individual maintain the household without being its occupant. The individual and the dependent described in subparagraph (1)(ii)(*a*) of this paragraph must occupy the household for more than one-half of the taxable year of the individual. However, the fact that such dependent is born or dies within the taxable year will not prevent an individual from qualifying for such treatment if the household constitutes the principal place of abode of such dependent for the remaining or preceding part of such taxable year. The individual and such dependent will be considered as occupying the household during temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which a child or stepchild is absent for less than 6 months in the taxable year of the taxpayer, shall be considered a temporary absence due to special circumstances. Such absence will not prevent an individual from qualifying for the treatment provided in subparagraph (1) of this paragraph if (i) it is reasonable to assume that such individual or the dependent will return to the household and (ii) such individual continues to maintain such household or a substantially equivalent household in anticipation of such return.

(4) An individual shall be considered as maintaining a household only if he pays more than one-half of the cost thereof for his taxable year. The cost of maintaining a household shall be the expenses incurred for the mutual benefit of the occupants thereof by reason of its operation as the principal place of abode of such occupants for such taxable year. The cost of maintaining a household shall not include expenses otherwise incurred. The expenses of maintaining a household include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises. Such expenses do not include the cost of clothing, education, medical treatment, vacations, life insurance, and transportation. In addition, the cost of maintaining a household shall not include any amount which represents the value of services rendered in the household by the taxpayer or by a dependent described in subparagraph (1)(ii)(*a*) of this paragraph.

(5) For purposes of subparagraph (1)(iv) of this paragraph, an individual's spouse is not a member of the household during a taxable year if

such household does not constitute such spouse's place of abode at any time during such year. An individual's spouse will be considered to be a member of the household during temporary absences from the household due to special circumstances. A nonpermanent failure to occupy such household as his abode by reason of illness, education, business, vacation, or military service shall be considered a mere temporary absence due to special circumstances.

(6) The provisions of this paragraph may be illustrated by the following example:

Example. Taxpayer A, married to B at the close of the calendar year 1971, his taxable year, is living apart from B, but A is not legally separated from B under a decree of divorce or separate maintenance. A maintains a household as his home which is for 7 months of 1971 the principal place of abode of C, his son, with respect to whom A is entitled to a deduction under section 151. A pays for more than one-half the cost of maintaining that household. At no time during 1971 was B a member of the household occupied by A and C. A files a separate return for 1971. Under these circumstances, A is considered as not married under section 143(b) for purposes of the standard deduction. Even though A is married and files a separate return A may claim for 1971 as his standard deduction the larger of the low income allowance up to a maximum of $1,050 consisting of both the basic allowance and additional allowance (rather than the basic allowance only subject to the $500 limitation applicable to a separate return of a married individual) or the percentage standard deduction subject to the $1,500 limitation (rather than the $750 limitation applicable to a separate return of a married individual). See § 1.141-1. For purposes of the provisions of part IV of subchapter B of chapter 1 of the Code and the regulations thereunder, A is treated as unmarried.

[T.D. 7123, 36 FR 11086, June 9, 1971]

§ 1.144-1 Manner and effect of election to take the standard deduction.

The following rules are prescribed with respect to the manner of signifying an election by a taxpayer to take the standard deduction:

(a) In the case of a taxpayer whose adjusted gross income for the taxable year for which a return is required or permitted to be filed on Form 1040 is $5,000 or more, the standard deduction shall be allowed to him if he elects on such return to take such deduction. Such taxpayer shall signify on his return his election to take the standard deduction by claiming thereon the deduction in the amount provided for in section 141 instead of itemizing the deductions (other than those specified in sections 62 and 151) allowable in computing taxable income. A taxpayer shall have signified his election to take the standard deduction if his return is filed on Form 1040A. If in any case the adjusted gross income shown on the return of the taxpayer is $5,000 or more, but the correct adjusted gross income is less than $5,000, then:

(1) If the taxpayer has elected on his return to take the standard deduction, he shall be deemed to have elected to pay the tax imposed by section 3; and

(2) If the taxpayer has not elected to take the standard deduction, he shall be deemed not to have elected to pay the tax imposed by section 3.

(b) In the case of a taxpayer whose adjusted gross income for the taxable year for which a return is required or permitted to be filed on Form 1040 is less than $5,000, the standard deduction shall be allowed to him only if he elects, in accordance with the regulations under section 4, to pay the optional tax imposed by section 3. The filing of such return on Form 1040A constitutes an election by the taxpayer to pay the tax imposed by section 3. In any case, however, in which adjusted gross income shown on the return is less than $5,000, but the correct adjusted gross income is in fact $5,000 or more, then:

(1) If the taxpayer has elected to pay the tax imposed by section 3, he shall be deemed to have elected to take the standard deduction; and

(2) If the taxpayer has not elected to pay the tax imposed by section 3, he shall be deemed not to have elected to take the standard deduction.

(c) In the case of a husband and wife (whether separate or joint returns are filed), the election to take the standard deduction and the manner of signifying such election shall, to the extent not limited by section 142 and the regulations thereunder, be made in accordance with the rules provided in paragraphs (a) and (b) of this section.

(d) For determination of marital status, see § 1.143-1.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6581, 26 FR 11677, Dec. 6, 1961; T.D. 7123, 36 FR 11087, June 9, 1971]

§ 1.144-2 Change of election with respect to the standard deduction.

(a) A change of the election with respect to the standard deduction for any taxable year may be made before or after the time prescribed for filing the return for the taxable year. However, the period of time prescribed in section 6511 within which claim for credit or refund of tax must be made is not extended by the right to effect a change of election.

(b) If the spouse of the taxpayer filed a separate return for any taxable year that corresponds, for the purpose of section 142(a), to the taxable year of the taxpayer, a change of election may not be made by the taxpayer unless: (1) The spouse makes a change of election in such separate return with respect to the standard deduction consistent with the change of election sought by the taxpayer, and (2) the taxpayer and his spouse file with the district director for the district in which the taxpayer applies for the change of election a consent in writing to the assessment, within such period of time as may be agreed upon with such district director, of any deficiency of either the taxpayer or his spouse to the extent attributable to such change of election, even though at the time of the filing of such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

(c) A change of election for any taxable year shall not be permitted if the tax liability of the taxpayer for the taxable year, or of the taxpayer's spouse for the taxable year corresponding, for the purpose of section 142(a), to the taxable year of the taxpayer, has been compromised under the provisions of section 7122.

(d) A change of election with respect to the standard deduction means:

(1) A change of election to take, or not to take, the standard deduction;

(2) A change of an election to pay, or not to pay, the tax under section 3; or

(3) In the case of a taxable year beginning after December 31, 1963, a change of an election under section 141(d)(2).

(e) For determination of marital status, see § 1.143-1.

[T.D. 6500, 25 FR 11402, Nov. 16, 1960, as amended by T.D. 6792, 30 FR 531, Jan. 15, 1965; T.D. 7123, 36 FR 11087, June 9, 1971]

§ 1.144-3 Standard deduction for individuals choosing income averaging.

(a) In the case of an individual who chooses under section 1304(a) to have the benefits of Part I of Subchapter Q (relating to income averaging) for the taxable year—

(1) Section 144(a) shall not apply, and

(2) The standard deduction under section 141 shall be allowed if an individual so elects in his return for such computation year.

Thus, even though an individual who chooses the benefits of income averaging for a taxable year may not pay the tax imposed under section 3, such individual may elect the standard deduction under section 141.

(b) The standard deduction shall be allowed to an individual if he elects on his return for the computation year to take such deduction. Such individual shall signify on his return his election to take the standard deduction by claiming thereon the deduction in the amount provided for in section 141 instead of itemizing the deductions (other than those specified in sections 62 and 151) allowable in computing taxable income. In the case of a husband and wife (whether separate or joint returns are filed), the election to take the standard deduction and the manner of signifying such election shall, to the extent not limited by section 142 and the regulations thereunder, be made in accordance with these rules.

(c) A change of the election to take, or not to take, the standard deduction for any computation year shall be made in accordance with the rules provided in § 1.144-2.

[T.D. 6885, 31 FR 7800, June 2, 1966]

DEDUCTIONS FOR PERSONAL EXEMPTIONS

§ 1.151-1 Deductions for personal exemptions.

(a) *In general.* (1) In computing taxable income, an individual is allowed a deduction for the exemptions specified in section 151. Such exemptions are: (i) The exemptions for an individual taxpayer and spouse (the so-called personal exemptions); (ii) the additional exemptions for a taxpayer attaining the age of 65 years and spouse attaining the age of 65 years (the so-called old-age exemptions); (iii) the additional exemptions for a blind taxpayer and a blind spouse; and (iv) the exemptions for dependents of the taxpayer.

(2) A nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year and subject to tax under section 1 or 1201(b) is allowed as deductions the exemptions specified in section 151, even though as to the United States such individual is a nonresident alien. See section 876 and the regulations thereunder, relating to alien residents of Puerto Rico.

(b) *Exemptions for individual taxpayer and spouse (so-called personal exemptions).* Section 151(b) allows an exemption for the taxpayer and an additional exemption for the spouse of the taxpayer if a joint return is not made by the taxpayer and his spouse, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer. Thus, a husband is not entitled to an exemption for his wife on his separate return for the taxable year beginning in a calendar year during which she has any gross income (though insufficient to require her to file a return). Since, in the case of a joint return, there are two taxpayers (although under section 6013 there is only one income for the two taxpayers on such return, i.e., their aggregate income), two exemptions are allowed on such return, one for each taxpayer spouse. If in any case a joint return is made by the taxpayer and his spouse, no other person is allowed an exemption for such spouse even though such other person would have been entitled to claim an exemption for such spouse as a dependent if such joint return had not been made.

(c) *Exemptions for taxpayer attaining the age of 65 and spouse attaining the age of 65 (so-called old-age exemptions).* (1) Section 151(c) provides an additional exemption for the taxpayer if he has attained the age of 65 before the close of his taxable year. An additional exemption is also allowed to the taxpayer for his spouse if a joint return is not made by the taxpayer and his spouse and if the spouse has attained the age of 65 before the close of the taxable year of the taxpayer and, for the calendar year in which the taxable year of the taxpayer begins, the spouse has no gross income and is not the dependent of another taxpayer. If a husband and wife make a joint return, an old-age exemption will be allowed as to each taxpayer spouse who has attained the age of 65 before the close of the taxable year for which the joint return is made. The exemptions under section 151(c) are in addition to the exemptions for the taxpayer and spouse under section 151(b).

(2) In determining the age of an individual for the purposes of the exemption for old age, the last day of the taxable year of the taxpayer is the controlling date. Thus, in the event of a separate return by a husband, no additional exemption for old age may be claimed for his spouse unless such spouse has attained the age of 65 on or before the close of the taxable year of the husband. In no event shall the additional exemption for old age be allowed with respect to a spouse who dies before attaining the age of 65 even though such spouse would have attained the age of 65 before the close of the taxable year of the taxpayer. For the purposes of the old-age exemption, an individual attains the age of 65 on the first moment of the day preceding his sixty-fifth birthday. Accordingly, an individual whose sixty-fifth birthday falls on January 1 in a given year attains the age of 65 on the last day of the calendar year immediately preceding.

(d) *Exemptions for the blind.* (1) Section 151(d) provides an additional exemption for the taxpayer if he is blind

at the close of his taxable year. An additional exemption is also allowed to the taxpayer for his spouse if the spouse is blind and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer. The determination of whether the spouse is blind shall be made as of the close of the taxable year of the taxpayer, unless the spouse dies during such taxable year, in which case such determination shall be made as of the time of such death.

(2) The exemptions for the blind are in addition to the exemptions for the taxpayer and spouse under section 151(b) and are also in addition to the exemptions under section 151(c) for taxpayers and spouses attaining the age of 65 years. Thus, a single individual who has attained the age of 65 before the close of his taxable year and who is blind at the close of his taxable year is entitled, in addition to the so-called personal exemption, to two further exemptions, one by reason of his age and the other by reason of his blindness. If a husband and wife make a joint return, an exemption for the blind will be allowed as to each taxpayer spouse who is blind at the close of the taxable year for which the joint return is made.

(3) A taxpayer claiming an exemption allowed by section 151(d) for a blind taxpayer and a blind spouse shall, if the individual for whom the exemption is claimed is not totally blind as of the last day of the taxable year of the taxpayer (or, in the case of a spouse who dies during such taxable year, as of the time of such death), attach to his return a certificate from a physician skilled in the diseases of the eye or a registered optometrist stating that as of the applicable status determination date in the opinion of such physician or optometrist (i) the central visual acuity of the individual for whom the exemption is claimed did not exceed 20/200 in the better eye with correcting lenses or (ii) such individual's visual acuity was accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees. If such individual is totally blind as of the status determination date there shall be attached to the return a statement by the person or persons making the return setting forth such fact.

(4) Notwithstanding subparagraph (3) of this paragraph, this subparagraph may be applied where the individual for whom an exemption under section 151(d) is claimed is not totally blind, and in the certified opinion of an examining physician skilled in the diseases of the eye there is no reasonable probability that the individual's visual acuity will ever improve beyond the minimum standards described in subparagraph (3) of this paragraph. In this event, if the examination occurs during a taxable year for which the exemption is claimed, and the examining physician certifies that, in his opinion, the condition is irreversible, and a copy of this certification is filed with the return for that taxable year, then a statement described in subparagraph (3) of this paragraph need not be attached to such individual's return for subsequent taxable years so long as the condition remains irreversible. The taxpayer shall retain a copy of the certified opinion in his records, and a statement referring to such opinion shall be attached to future returns claiming the section 151(d) exemption.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7114, 36 FR 9018, May 18, 1971; T.D. 7230, 37 FR 28288, Dec. 22, 1972]

§ 1.151-2 Additional exemptions for dependents.

(a) Section 151(e) allows to a taxpayer an exemption for each dependent (as defined in section 152) whose gross income (as defined in section 61) for the calendar year in which the taxable year of the taxpayer begins is less than the amount provided in section 151(e)(1)(A) applicable to the taxable year of the taxpayer, or who is a child of the taxpayer and who—

(1) The taxable year of the taxpayer begins, or

(2) Is a student, as defined in paragraph (b) of § 1.151-3.

No exemption shall be allowed under section 151(e) for any dependent who has made a joint return with his spouse under section 6013 for the tax-

able year beginning in the calendar year in which the taxable year of the taxpayer begins. The amount provided in section 151(e)(1)(A) is $750 in the case of a taxable year beginning after December 31, 1972; $700 in the case of a taxable year beginning after December 31, 1971, and before January 1, 1973; $650 in the case of a taxable year beginning after December 31, 1970, and before January 1, 1972; $625 in the case of a taxable year beginning after December 31, 1969, and before January 1, 1971; and $600 in the case of a taxable year beginning before January 1, 1970. For special rules in the case of a taxpayer whose taxable year is a fiscal year ending after December 31, 1969, and beginning before January 1, 1973, see section 21(d) and the regulations thereunder.

(b) The only exemption allowed for a dependent of the taxpayer is that provided by section 151(e). The exemptions provided by section 151(c) (old-age exemptions) and section 151(d) (exemptions for the blind) are allowed only for the taxpayer or his spouse. For example, where a taxpayer provides the entire support for his father who meets all the requirements of a dependent, he is entitled to only one exemption for his father (section 151(e)), even though his father is over the age of 65.

[T.D. 7114, 36 FR 9019, May 18, 1971]

§ 1.151-3 Definitions.

(a) *Child.* For purposes of sections 151(e), 152, and the regulations thereunder, the term "child" means a son, stepson, daughter, stepdaughter, adopted son, adopted daughter, or for taxable years beginning after December 31, 1958, a child who is a member of an individual's household if the child was placed with the individual by an authorized placement agency for legal adoption pursuant to a formal application filed by the individual with the agency (see paragraph (c)(2) of § 1.152-2), or, for taxable years beginning after December 31, 1969, a foster child (if such foster child satisfies the requirements set forth in paragraph (b) of § 1.152-1 with respect to the taxpayer) of the taxpayer.

(b) *Student.* For purposes of section 151(e) and section 152(d), and the regulations thereunder, the term "student" means an individual who during each of 5 calendar months during the calendar year in which the taxable year of the taxpayer begins is a full-time student at an educational institution or is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational institution or of a state or political subdivision of a State. An example of "institutional on-farm training" is that authorized by 38 U.S.C. 1652 (formerly section 252 of the Veterans' Readjustment Assistance Act of 1952), as described in section 252 of such act. A full-time student is one who is enrolled for some part of 5 calendar months for the number of hours or courses which is considered to be full-time attendance. The 5 calendar months need not be consecutive. School attendance exclusively at night does not constitute full-time attendance. However, full-time attendance at an educational institution may include some attendance at night in connection with a full-time course of study.

(c) *Educational institution.* For purposes of sections 151(e) and 152, and the regulations thereunder, the term "educational institution" means a school maintaining a regular faculty and established curriculum, and having an organized body of students in attendance. It includes primary and secondary schools, colleges, universities, normal schools, technical schools, mechanical schools, and similar institutions, but does not include noneducational institutions, on-the-job training, correspondence schools, night schools, and so forth.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7051, 35 FR 11020, July 9, 1970]

§ 1.151-4 Amount of deduction for each exemption under section 151.

The amount allowed as a deduction for each exemption under section 151 is (a) $750 in the case of a taxable year beginning after December 31, 1972; (b) $700 in the case of a taxable year beginning after December 31, 1971, and

before January 1, 1973; (c) $650 in the case of a taxable year beginning after December 31, 1970, and before January 1, 1972; (d) $625 in the case of a taxable year beginning after December 31, 1969, and before January 1, 1971; and (e) $600 in the case of a taxable year beginning before January 1, 1970. For special rules in the case of a fiscal year ending after December 31, 1969, and beginning before January 1, 1973, see section 21(d) and the regulations thereunder.

[T.D. 7114, 36 FR 9019, May 18, 1971]

§ 1.152-1 General definition of a dependent.

(a) (1) For purposes of the income taxes imposed on individuals by chapter 1 of the Code, the term "dependent" means any individual described in paragraphs (1) through (10) of section 152(a) over half of whose support, for the calendar year in which the taxable year of the taxpayer begins, was received from the taxpayer.

(2) (i) For purposes of determining whether or not an individual received, for a given calendar year, over half of his support from the taxpayer, there shall be taken into account the amount of support received from the taxpayer as compared to the entire amount of support which the individual received from all sources, including support which the individual himself supplied. The term "support" includes food, shelter, clothing, medical and dental care, education, and the like. Generally, the amount of an item of support will be the amount of expense incurred by the one furnishing such item. If the item of support furnished an individual is in the form of property or lodging, it will be necessary to measure the amount of such item of support in terms of its fair market value.

(ii) In computing the amount which is contributed for the support of an individual, there must be included any amount which is contributed by such individual for his own support, including income which is ordinarily excludable from gross income, such as benefits received under the Social Security Act (42 U.S.C. ch. 7). For example, a father receives $800 social security benefits, $400 interest, and $1,000 from his son during 1955, all of which sums represent his sole support during that year. The fact that the social security benefits of $800 are not includible in the father's gross income does not prevent such amount from entering into the computation of the total amount contributed for the father's support. Consequently, since the son's contribution of $1,000 was less than one-half of the father's support ($2,200) he may not claim his father as a dependent.

(iii) (*a*) For purposes of determining the amount of support furnished for a child (or children) by a taxpayer for a given calendar year, an arrearage payment made in a year subsequent to a calendar year for which there is an unpaid liability shall not be treated as paid either during that calendar year or in the year of payment, but no amount shall be treated as an arrearage payment to the extent that there is an unpaid liability (determined without regard to such payment) with respect to the support of a child for the taxable year of payment; and

(*b*) Similarly, payments made prior to any calendar year (whether or not made in the form of a lump sum payment in settlement of the parent's liability for support) shall not be treated as made during such calendar year, but payments made during any calendar year from amounts set aside in trust by a parent in a prior year, shall be treated as made during the calendar year in which paid.

(b) Section 152(a)(9) applies to any individual (other than an individual who at any time during the taxable year was the spouse, determined without regard to section 153, of the taxpayer) who lives with the taxpayer and is a member of the taxpayer's household during the entire taxable year of the taxpayer. An individual is not a member of the taxpayer's household if at any time during the taxable year of the taxpayer the relationship between such individual and the taxpayer is in violation of local law. It is not necessary under section 152(a)(9) that the dependent be related to the taxpayer. For example, foster children may qualify as dependents. It is necessary, however, that the taxpayer both maintain and occupy the household.

The taxpayer and dependent will be considered as occupying the household for such entire taxable year notwithstanding temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which the dependent is absent for less than six months in the taxable year of the taxpayer, shall be considered temporary absence due to special circumstances. The fact that the dependent dies during the year shall not deprive the taxpayer of the deduction if the dependent lived in the household for the entire part of the year preceding his death. Likewise, the period during the taxable year preceding the birth of an individual shall not prevent such individual from qualifying as a dependent under section 152(a)(9). Moreover, a child who actually becomes a member of the taxpayer's household during the taxable year shall not be prevented from being considered a member of such household for the entire taxable year, if the child is required to remain in a hospital for a period following its birth, and if such child would otherwise have been a member of the taxpayer's household during such period.

(c) In the case of a child of the taxpayer who is under 19 or who is a student, the taxpayer may claim the dependency exemption for such child provided he has furnished more than one-half of the support of such child for the calendar year in which the taxable year of the taxpayer begins, even though the income of the child for such calendar year may be equal to or in excess of the amount determined pursuant to § 1.151-2 applicable to such calendar year. In such a case, there may be two exemptions claimed for the child: One on the parent's (or stepparent's) return, and one on the child's return. In determining whether the taxpayer does in fact furnish more than one-half of the support of an individual who is a child, as defined in paragraph (a) of § 1.151-3, of the taxpayer and who is a student, as defined in paragraph (b) of § 1.151-3, a special rule regarding scholarships applies. Amounts received as scholarships, as defined in paragraph (a) of § 1.117-3, for study at an educational institution shall not be considered in determining whether the taxpayer furnishes more than one-half the support of such individual. For example, A has a child who receives a $1,000 scholarship to the X college for 1 year. A contributes $500, which constitutes the balance of the child's support for that year. A may claim the child as a dependent, as the $1,000 scholarship is not counted in determining the support of the child. For purposes of this paragraph, amounts received for tuition payments and allowances by a veteran under the provisions of the Servicemen's Readjustment Act of 1944 (58 Stat. 284) or the Veterans' Readjustment Assistance Act of 1952 (38 U.S.C. ch. 38) are not amounts received as scholarships. See also § 1.117-4. For definition of the terms "child", "student", and "educational institution", as used in this paragraph, see § 1.151-3.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6603, 28 FR 7094, July 11, 1963; T.D. 7099, 36 FR 5337, Mar. 20, 1971; T.D. 7114, 36 FR 9019, May 18, 1971]

§ 1.152-2 Rules relating to general definition of dependent.

(a)(1) Except as provided in subparagraph (2) of this paragraph, to qualify as a dependent an individual must be a citizen or resident of the United States or be a resident of the Canal Zone, the Republic of Panama, Canada, or Mexico, or, for taxable years beginning after December 31, 1971, a national of the United States, at some time during the calendar year in which the taxable year of the taxpayer begins. A resident of the Republic of the Philippines who was born to or legally adopted by the taxpayer in the Philippine Islands before January 1, 1956, at a time when the taxpayer was a member of the Armed Forces of the United States, may also be claimed as a dependent if such resident otherwise qualifies as a dependent. For definition of "Armed Forces of the United States," see section 7701(a)(15).

(2)(i) For any taxable year beginning after December 31, 1957, a taxpayer who is a citizen, or, for any taxable year beginning after December 31,

1971, a national, of the United States is permitted under section 152(b)(3)(B) to treat as a dependent his legally adopted child who lives with him, as a member of his household, for the entire taxable year and who, but for the citizenship, nationality, or residence requirements of section 152(b)(3) and subparagraph (1) of this paragraph, would qualify as a dependent of the taxpayer for such taxable year.

(ii) Under section 152(b)(3)(B) and this subparagraph, it is necessary that the taxpayer both maintain and occupy the household. The taxpayer and his legally adopted child will be considered as occupying the household for the entire taxable year of the taxpayer notwithstanding temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which the legally adopted child is absent for less than six months in the taxable year of the taxpayer shall be considered temporary absence due to special circumstances. The fact that a legally adopted child dies during the year shall not deprive the taxpayer of the deduction if the child lived in the household for the entire part of the year preceding his death. The period during the taxable year preceding the birth of a child shall not prevent such child from qualifying as a dependent under this subparagraph. Moreover, a legally adopted child who actually becomes a member of the taxpayer's household during the taxable year shall not be prevented from being considered a member of such household for the entire taxable year, if the child is required to remain in a hospital for a period following its birth and if such child would otherwise have been a member of the taxpayer's household during such period.

(iii) For purposes of section 152(b)(3)(B) and this subparagraph, any child whose legal adoption by the taxpayer (a citizen or national of the United States) becomes final at any time before the end of the taxable year of the taxpayer shall not be disqualified as a dependent of such taxpayer by reason of his citizenship, nationality, or residence, provided the child lived with the taxpayer and was a member of the taxpayer's household for the entire taxable year in which the legal adoption became final. For example, A, a citizen of the United States who makes his income tax returns on the basis of the calendar year, is employed in Brazil by an agency of the United States Government. In October 1958 he takes into his household C, a resident of Brazil who is not a citizen of the United States, for the purpose of initiating adoption proceedings. C lives with A and is a member of his household for the remainder of 1958 and for the entire calendar year 1959. On July 1, 1959, the adoption proceedings were completed and C became the legally adopted child of A. If C otherwise qualifies as a dependent, he may be claimed as a dependent by A for 1959.

(b) A payment to a wife which is includible in her gross income under section 71 or section 682 shall not be considered a payment by her husband for the support of any dependent.

(c) (1) For purposes of determining the existence of any of the relationships specified in section 152 (a) or (b)(1), a legally adopted child of an individual shall be treated as a child of such individual by blood.

(2) For any taxable year beginning after December 31, 1958, a child who is a member of an individual's household also shall be treated as a child of such individual by blood if the child was placed with the individual by an authorized placement agency for legal adoption pursuant to a formal application filed by the individual with the agency. For purposes of this subparagraph an authorized placement agency is any agency which is authorized by a State, the District of Columbia, a possession of the United States, a foreign country, or a political subdivision of any of the foregoing to place children for adoption. A taxpayer who claims as a dependent a child placed with him for adoption shall attach to his income tax return a statement setting forth the name of the child for whom the dependency deduction is claimed, the name and address of the authorized placement agency, and the date the

formal application was filed with the agency.

(3) The application of this paragraph may be illustrated by the following example:

Example. On March 1, 1959, D, a resident of the United States, made formal application to an authorized child placement agency for the placement of E, a resident of the United States, with him for legal adoption. On June 1, 1959, E was placed with D for legal adoption. During the year 1959 E received over one-half of his support from D. D may claim E as a dependent for 1959. Since E was a resident of the United States, his qualification as a dependent is in no way based on the provisions of section 152(b)(3)(B). Therefore, it is immaterial that E was not a member of D's household during the entire taxable year.

(4) For purposes of determining the existence of any of the relationships specified in section 152 (a) or (b)(1), a foster child of an individual (if such foster child satisfies the requirements set forth in paragraph (b) of § 1.152-1 with respect to such individual) shall, for taxable years beginning after December 31, 1969, be treated as a child of such individual by blood. For purposes of this subparagraph, a foster child is a child who is in the care of a person or persons (other than the parents or adopted parents of the child) who care for the child as their own child. Status as a foster child is not dependent upon or affected by the circumstances under which the child became a member of the household.

(d) In the case of a joint return it is not necessary that the prescribed relationship exist between the person claimed as a dependent and the spouse who furnishes the support; it is sufficient if the prescribed relationship exists with respect to either spouse. Thus, a husband and wife making a joint return may claim as a dependent a daughter of the wife's brother (wife's niece) even though the husband is the one who furnishes the chief support. The relationship of affinity once existing will not terminate by divorce or the death of a spouse. For example, a widower may continue to claim his deceased wife's father (his father-in-law) as a dependent provided he meets the other requirements of section 151.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6603, 28 FR 7094, July 11, 1963; T.D. 7051, 35 FR 11020, July 9, 1970; T.D. 7291, 38 FR 33396, Dec. 4, 1973]

§ 1.152-3 Multiple support agreements.

(a) Section 152(c) provides that a taxpayer shall be treated as having contributed over half of the support of an individual for the calendar year (in cases where two or more taxpayers contributed to the support of such individual) if—

(1) No one person contributed over half of the individual's support,

(2) Each member of the group which collectively contributed more than half of the support of the individual would have been entitled to claim the individual as a dependent but for the fact that he did not contribute more than one-half of such support.

(3) The member of the group claiming the individual as a dependent contributed more than 10 percent of the individual's support, and

(4) Each other person in the group who contributed more than 10 percent of such support files a written declaration that he will not claim the individual as a dependent for any taxable year beginning in such calendar year.

(b) Application of the rule contained in paragraph (a) of this section may be illustrated by the following examples:

Example (1). Brothers A, B, C, and D contributed the entire support of their mother in 1956 in the following percentages: A, 30 percent; B, 20 percent; C, 29 percent; and D, 21 percent. Any one of the brothers, except for the fact that he did not contribute more than half of her support, would have been entitled to claim his mother as a dependent. Consequently, any one of the brothers could claim a deduction for the exemption of the mother provided a written declaration (as provided in paragraph (c) of this section) from each of the other brothers is attached to his income tax return. Even though A and D together contributed more than one-half the support of the mother, A, if he wished to claim his mother as a dependent, would be required to attach written declarations from B, C, and D to his income tax return, since each of those three contributed more than 10 percent of the support and, but for the support requirement, would have been entitled to claim his mother as a dependent.

Example (2). E, an individual who resides with his son, received $1,500 during the cal-

endar year 1956, which constituted his entire support for that year. The source of the $1,500 was as follows:

Source	Amount received	Percentage of total
Social Security	$375	25
N, an unrelated neighbor	165	11
B, a brother	210	14
D, a daughter	150	10
S, a son	600	40
Total received by E	1,500	100

B, D, and S are persons each of whom, but for the fact that he did not contribute more than half of the $1,500, could claim E as a dependent for a taxable year beginning in 1956. The three together contributed $960, or 64 percent of the $1,500, and, thus, each is a member of the group to be considered for the purpose of section 152(c). B and S are the only members of such group who can meet all the requirements of section 152(c) and either one could claim E as a dependent for his taxable year beginning in 1956 provided he attached to his income tax return a written declaration (as provided in paragraph (c) of this section) signed by the other, and furnished the other information required by the return with respect to all the contributions to E. Inasmuch as D did not contribute more than 10 percent of E's support, she is not entitled to claim E as a dependent for a taxable year beginning in 1956 nor is she required to file a written declaration with respect to her contributions to E. N contributed over 10 percent of the support of E in 1956 but, since he is an unrelated neighbor, he does not qualify as a member of the group for the purpose of the multiple support agreement under section 152(c).

(c) The member of a group of contributors who claim an individual as a dependent under the multiple support agreement provisions of section 152(c) must attach to his income tax return for the year of the deduction a written declaration from each of the other persons who contributed more than 10 percent of the support of such individual and who, but for the failure to contribute more than half of the support of the individual, would have been entitled to claim the individual as a dependent. The written declaration required by this paragraph may be made on Form 2120. Any declaration made other than on Form 2120 shall conform to the substance of Form 2120. The taxpayer claiming the individual as a dependent should be prepared to furnish other information, when required, which will substantiate his right to claim such individual as a dependent. Such information may include a statement showing the names of all contributors (whether or not members of the group described in section 152(c)) and the amount contributed by each to the support of the claimed dependent.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6603, 28 FR 7094, July 11, 1963]

§ 1.152-4 Support test in case of child of divorced or separated parents.

(a) *Applicability.* For taxable years beginning after December 31, 1966, the provisions of section 152(e) and this section relate to a determination of which of separated parents (that is, parents who are divorced or legally separated under a decree of divorce or separate maintenance, or separated under a written separation agreement) is to be treated for purposes of section 152(a) and § 1.152-1 as having provided more than half of the support of a child, as defined in section 151(e)(3) and § 1.151-3(a). For section 152(e) and this section to apply either parent or both parents combined must provide more than one-half of the child's total support, within the meaning of § 1.152-1(a)(2)(i) during the calendar year in which the taxable year of the parent who is claiming the child as a dependent begins; and such child must be in the custody of one or both of his parents for more than one-half of the calendar year. Thus, section 152(e) and this section do not apply if a person other than the parents provides one-half or more for the support of such child during the calendar year or has custody of the child for one-half or more of the calendar year. In addition, section 152(e) and this section do not apply in any case where over half of the support of the child is treated as having been received from a taxpayer pursuant to a multiple support agreement under the provisions of section 152(c) and § 1.152-3. Nor does section 152(e) and this section apply to a period for which a joint return signed by both parents is filed.

(b) *Custody.* "Custody," for purposes of this section, will be determined by the terms of the most recent decree of divorce or separate maintenance, or subsequent custody decree, or, if none, a written separation agreement. In the event of so-called "split" custody, or if neither a decree or agreement establishes who has custody, or if the validity or continuing effect of such decree or agreement is uncertain by reason of proceedings pending on the last day of the calendar year, "custody" will be deemed to be with the parent who, as between both parents, has the physical custody of the child for the greater portion of the calendar year.

(c) *General rule.* For purposes of section 152(a) and § 1.152–1, a child shall be treated as receiving over half of his support during the calendar year from the parent (hereinafter referred to as the "custodial parent") having custody within the meaning of paragraph (b) of this section for a greater portion of the calendar year unless the exceptions of paragraph (d) of this section apply. If the parents of such a child are divorced or separated for only a portion of a calendar year after having had joint custody of the child for the prior portion of the year, the parent who has custody for the greater portion of the remainder of the year after divorce or separation shall be treated as having custody for a greater portion of the calendar year. Except as provided in section 152(e)(2)(A) and paragraph (d)(2) of this section (relating to decree or agreement) parents who are unable to enter into a multiple support agreement under section 152(c) cannot enter into an agreement as to which parent is entitled to claim a child as a dependent. Therefore, in general, the custodial parent shall be allowed as a deduction the exemption for the dependent child, if the requirements of section 151(e) are met.

(d) *Exceptions*—(1) *In general.* Notwithstanding paragraph (c) of this section, a child shall be treated as receiving over half of his support during the calendar year from the parent who is not the custodial parent (hereinafter referred to as the "noncustodial parent") if the conditions of subparagraph (2) or (3) of this paragraph are met.

(2) *Decree or agreement.* A noncustodial parent who provides at least $600 for the support of a child during the calendar year shall be treated as having provided more than half the support of the child if the decree of divorce or of separate maintenance, or a written agreement between the parents applicable to the taxable year of the noncustodial parent beginning in such calendar year, provides that the noncustodial parent shall be entitled to any deduction allowable under section 151 as an exemption for the dependent child. In order for this subparagraph to apply, the noncustodial parent must provide at least $600 for the support of each child he claims as a dependent. For taxable years beginning after December 31, 1970, in the case of a written agreement or portion of a written agreement between the parents which allocates the deduction to the noncustodial parent, the noncustodial parent must attach to his return (or amended return) a copy of such agreement or such portion of such agreement which is applicable to the calendar year in which the taxable year of the noncustodial parent begins.

(3) *Actual support.* A noncustodial parent who provides $1,200 or more support for the child (or, for taxable years beginning before October 5, 1976, if there is more than one child for which he claims an exemption, $1,200 or more for the combined support for all of such children) shall be treated as having provided more than half the support for the child (or children) notwithstanding any provision to the contrary contained in a decree of divorce or separation or in a written agreement, unless the custodial parent clearly established that the custodial parent provided, in fact, more for the support of the child during the calendar year than the noncustodial parent. Under section 152(e)(2)(B) and this subparagraph, if the noncustodial parent established that the noncustodial parent has provided $1,200 or more for support of the child, then the custodial parent has the burden of establishing by a clear preponderance of the evidence that the custodial parent has provided more for the support of the child than has been estab-

lished by the noncustodial parent in order to be treated as having provided over half of the support of the child. See paragraph (e) of this section with regard to notification and submission of itemized statements.

(4) *Amount of support.* For purposes of this paragraph, amounts expended for the support of a child shall be treated as received from the noncustodial parent to the extent that the noncustodial parent provided amounts for the support of the child, whether or not such amounts provided by the noncustodial parent are actually expended for child support. Therefore, for example, if only the parents have provided support for the child during a calendar year, only the excess of the total amount expended for the support of the child over the amount so provided by the noncustodial parent shall be treated as provided by the custodial parent for the support of the child.

(e) *Itemized statement*—(1) *Exchange.* (i) If a parent intends to claim for a taxable year a child as a dependent or a parent is uncertain whether he is entitled to claim a child and desires either to determine whether the second parent intends to or has claimed the same child as a dependent, or if the first parent desires to receive an itemized statement as provided in subparagraph (3) of this paragraph from the second parent, the first parent is entitled to receive such information from the second parent in writing upon request provided he both notifies the second parent of his intention (or possible intention) to so claim the child and sends the second parent a copy of such an itemized statement upon which the first parent's claim is based. A failure to make such a request shall not affect the right of the first parent to claim the child as a dependent. However, if the first parent makes such a request, and the second parent does not respond within a reasonable time, and it is determined that the first parent is not entitled to claim the child as a dependent, the inability of the first parent to obtain information will be taken into account in determining whether the addition to tax under section 6653, relating to failure to pay tax, is applicable.

(ii) Upon receipt of such a request accompanied by an itemized statement, if the second parent intends to claim (with respect to the calendar year in which such taxable year of the first parent begins) or has claimed the same child as a dependent, the second parent shall so inform the first parent, and if so requested shall send him a copy of the itemized statement upon which the second parent's claim is based. A notification under this subparagraph that the parent is claiming or is not claiming the child as a dependent shall not affect the rights of the parent making such notification and does not constitute a waiver.

(2) *Attachment to return.* For taxable years beginning after December 31, 1970, if a parent intends to claim a child as a dependent and, prior to the filing of his return or the time prescribed by law for filing the return (determined without regard to any extension thereof), whichever is later, such parent makes or receives a request under the procedures provided under paragraph (e)(1) of this section, then unless he is reasonably certain that the other parent will not claim the child as a dependent, such parent must attach to his return (or if the return is already filed, to a corrected or amended return) a copy of the itemized statement upon which such parent's claim is based, as provided in subparagraph (3) of this paragraph, together with a copy of the other parent's itemized statement, if available, at the time the return is filed. Failure to attach an itemized statement to the extent required by this subparagraph will be taken into account in determining whether the addition to tax under section 6653, relating to failure to pay tax, is applicable in the event it is determined that the parent is not entitled to claim the child as a dependent.

(3) *Contents.* The itemized statement referred to in subparagraphs (1) and (2) of this paragraph shall include—

(i) The name of the child (or children) being claimed as a dependent as well as the name of both parents and, if known, the address and social security number of both parents;

(ii) If known, the number of months the dependent child (or children) lived

during the calendar year in the home of each parent or person other than the parents;

(iii) If known, income for the taxable year of each dependent child;

(iv) If known, the total amount of support furnished the child (or children) (including amounts furnished by persons other than the parents);

(v) A list of amounts expended during the calendar year for the child (or children) made by the parent making the statement and itemized to show the amounts expended for medical and dental care, food, shelter, clothing, education, recreation, and transportation;

(vi) Amounts actually paid by the parent making the statement during the calendar year for the support of the child (or children) pursuant to a decree of divorce or separate maintenance, or a written separation agreement; and

(vii) Other amounts paid or expended by the parent making the statement during the calendar year, for the support of the child (or children).

(4) *Requirement by officer.* Notwithstanding subparagraph (1), (2), or (3) of this paragraph, an internal revenue officer may require the submission of an itemized statement from either parent and may make it available to the other parent. Such itemized statement shall contain the information requested by the internal revenue officer and shall be filed within such reasonable time as may be designated by him. If the required statement is not furnished pursuant to the instructions of the internal revenue officer, the claim of support of the parent failing to comply with such requirement may be disallowed by the Internal Revenue Service.

(f) *Illustration of principles.* The application of the provisions of this section may be illustrated by the following examples:

Example (1). A, a child of B and C, who were divorced June 1, 1970, received $1,000 for support during the calendar year 1970, of which $400 was provided by B and $300 was provided by C. No multiple support agreement was entered into. Prior to the divorce B and C jointly had custody of A, and for the remainder of 1970, B had custody of A for the months of October through December, while C had custody of A for the months of June through September. Since C had custody for 4 of the 7 months following the divorce, C is the custodial parent for 1970 and is treated as having provided over half of the support for A during 1970.

Example (2). Assume the same facts as in example (1) and that for the calendar year 1971, of $1,000 support expended for A during 1971, $400 was provided by B and $300 was provided by C. Furthermore, assume that in addition to having custody of A for the months of October through December 1971, B had custody for the first 5 months of 1971. Since B had custody of A for a total of 8 months in 1971, B is the custodial parent for 1971 and is treated as having provided over half of the support for A during 1971.

Example (3). D received all of his support, $1,000, during the calendar year 1970, from his parents E and F, who are separated under a written separation agreement. F had custody of D for the entire year of 1970, but under the agreement E was to provide $600 for the support of D during 1970, and E is entitled to any deduction allowable under section 151 for the years 1970 and 1971. E, in fact, provides only $550 for the support of D during 1970, but makes up the arrearage of $50 early in 1971. Nevertheless, F is treated as having provided over half of the support for D during 1970.

Example (4). Assume the same facts as in example (3) and that F had custody of D for the entire year 1971, and of $2,350 expended for the support of D during 1971, E provided $650 while F provided $1,700. Since under the written separation agreement E is entitled to any deduction allowable under section 151 for D for the year 1971 and E provided at least $600 for the support of D, E is treated as having provided over half of the support of D, for 1971.

Example (5). G and H are legally separated under a decree of separate maintenance. G has custody of I, the child of G and H, for the entire year, and G and H enter into a written agreement that G is entitled to any deduction allowable under section 151 for I for the calendar year 1970. However, during 1970, of the $2,000 provided for the support of I, H provided $1,300 while G provided only $700. H has provided more than $1,200 for the support of I, and G cannot establish that G provided more for the support of I, than did H. Therefore, notwithstanding the agreement, since H does not have custody of I, H is treated as having provided over half of the support for I for 1970.

Example (6). J and K, the children of L and M, who are divorced, received a total of $3,400 for the support of both during the calendar year 1970 from their parents. L, who has custody of J and K for the entire year 1970, provided $1,800 for the support of both, while M, the noncustodial parent,

provided $1,600 for such support. Under the decree of divorce, M is entitled to any deduction allowable under section 151 for such children. Since M has provided at least $600 for the support of each child, M is treated as having provided over half the support for J and K for 1970. Furthermore, as J and K are determined under section 152(e) and § 1.152-4 to be dependents of M for purposes of section 151(e), they are also considered to be dependents of M with respect to other provisions of the Code that are dependent upon such a determination for their operation. (For example, section 213.)

Example (7). N, O, and P are the children of divorced parents Q and R, both calendar year taxpayers. During calendar year 1976, the children received over half their support from Q and R. Q, who has custody of the three children for the entire year 1976, provided $800 for the support of each of the three children. R, the noncustodial parent, provided $2,700 during 1976 for the combined support of the three children under the terms of the decree of divorce. So, for calendar year 1976, although R, the noncustodial parent, did not provide support in the amount $1,200 per child under paragraph (d)(3) of this section, R, the noncustodial parent, is treated as having provided more than half the support of each child during 1976, since R provided more than $1,200 for the combined support of all the children and Q did not provide more for the support of either N, O, or P ($800 per child) during 1976 than R provided during 1976 ($900 per child).

Example (8). Assume the same facts that occurred in 1976 in example 7 also occurred in 1977. For 1977 R does not satisfy the $1,200 support test under paragraph (d)(3) of this section because he has not provided $1,200 support for each individual child N, O, or P for calendar year 1977. Therefore, R, the noncustodial parent, is not treated as having provided more than half the support of the children for calendar year 1977.

Example (9). A, B, and C, the children of divorced parents M and N, both calendar year taxpayers, receive all of their support, $5,900, from their parents during the calendar year 1979. M has custody of A, B, and C and provides $2,700 for their collective support during 1979. Pursuant to the terms of the decree of divorce N provided $1,200 for the support of A, $1,000 for the support of B, and $1,000 for the support of C. Since N has provided $1,200 or more for the support of A, and M has provided $900 ($2,700 – 3) for the support of A during 1979, N is treated as having provided more than half the support for A during 1979. However, since N has not provided $1,200 or more for the support of either B or C, N, the noncustodial parent, is not treated as having provided more than half the support of B or C during 1979.

[T.D. 7099, 36 FR 5337, Mar. 20, 1971, as amended by T.D. 7145, 36 FR 20039, Oct. 15, 1971; T.D. 7639, 44 FR 48674, Aug. 20, 1979]

§ 1.153–1 Determination of marital status.

For the purpose of determining the right of an individual to claim an exemption for his spouse under section 151(b), the determination of whether such individual is married shall be made as of the close of his taxable year, unless his spouse dies during such year, in which case the determination shall be made as of the time of such death. An individual legally separated from his spouse under a decree of divorce or separate maintenance shall not be considered as married. The provisions of this section may be illustrated by the following examples:

Example (1). A, who files his returns on the basis of a calendar year, married B on December 31, 1956. B, who had never previously married, had no gross income for the calendar year 1956 nor was she the dependent of another taxpayer for such year. A may claim an exemption for B for 1956.

Example (2). C and his wife, D, were married in 1940. They remained married until July 1956 at which time D was granted a decree of divorce. C, who files his income tax returns on a calendar year basis, cannot claim an exemption for D on his 1956 return as C and D were not married on the last day of C's taxable year. Had D died instead of being divorced, C could have claimed an exemption for D for 1956 as their marital status would have been determined as of the date of D's death.

§ 1.154 Statutory provisions; cross references.

SEC. 154. *Cross references.* (1) For definitions of "husband" and "wife", as used in section 152(b)(4), see section 7701(a)(17).

(2) For deductions of estates and trusts, in lieu of the exemptions under section 151, see section 642(b).

(3) For exemptions of nonresident aliens, see section 873(b)(3).

(4) For exemptions of citizens deriving income mainly from sources within possessions of the United States, see section 931(e).

[Sec. 154 as amended by sec. 103(c)(2), Foreign Investors Tax Act 1966 (80 Stat. 1551)]

[TD 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, as amended by T.D. 7332, 39 FR 44216, Dec. 23, 1974]

ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

§ 1.161-1 Allowance of deductions.

Section 161 provides for the allowance as deductions, in computing taxable income under section 63(a), of the items specified in part VI (section 161 and following), subchapter B, chapter 1 of the Code, subject to the exceptions provided in part IX (section 261 and following), of such subchapter B, relating to items not deductible. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code of 1954 cannot again be deducted under any other provision thereof. See also section 7852(c), relating to the taking into account, both in computing a tax under subtitle A of the Internal Revenue Code of 1954 and a tax under chapter 1 or 2 of the Internal Revenue Code of 1939, of the same item of deduction.

§ 1.162-1 Business expenses.

(a) *In general.* Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than section 162. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. See paragraph (a) of § 1.161-3. Among the items included in business expenses are management expenses, commissions (but see section 263 and the regulations thereunder), labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see § 1.162-2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. No such item shall be included in business expenses, however, to the extent that it is used by the taxpayer in computing the cost of property included in its inventory or used in determining the gain or loss basis of its plant, equipment, or other property. See section 1054 and the regulations thereunder. A deduction for an expense paid or incurred after December 30, 1969, which would otherwise be allowable under section 162 shall not be denied on the grounds that allowance of such deduction would frustrate a sharply defined public policy. See section 162(c), (f), and (g) and the regulations thereunder. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is deductible, even though such expenses exceed the gross income derived during the taxable year from such business. In the case of any sports program to which section 114 (relating to sports programs conducted for the American National Red Cross) applies, expenses described in section 114(a)(2) shall be allowable as deductions under section 162(a) only to the extent that such expenses exceed the amount excluded from gross income under section 114(a).

(b) *Cross references.* (1) For charitable contributions by individuals and corporations not deductible under section 162, see § 1.162-15.

(2) For items not deductible, see sections 261-276, inclusive, and the regulations thereunder.

(3) For research and experimental expenditures, see section 174 and regulations thereunder.

(4) For soil and water conservation expenditures, see section 175 and regulations thereunder.

(5) For expenditures attributable to grant or loan by United States for encouragement of exploration for, or development or mining of, critical and strategic minerals or metals, see section 621 and regulations thereunder.

(6) For treatment of certain rental payments with respect to public utility property, see section 167(1) and § 1.167(1)-3.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6690, 28 FR 12253, Nov. 19, 1963; T.D. 6996, 34 FR 835, Jan. 18, 1969; T.D. 7315, 39 FR 20203, June 7, 1974; T.D. 7345, 40 FR 7437, Feb. 20, 1975]

§ 1.162-2 Traveling expenses.

(a) Traveling expenses include travel fares, meals and lodging, and expenses incident to travel such as expenses for sample rooms, telephone and telegraph, public stenographers, etc. Only such traveling expenses as are reasonable and necessary in the conduct of the taxpayer's business and directly attributable to it may be deducted. If the trip is undertaken for other than business purposes, the travel fares and expenses incident to travel are personal expenses and the meals and lodging are living expenses. If the trip is solely on business, the reasonable and necessary traveling expenses, including travel fares, meals and lodging, and expenses incident to travel, are business expenses. For the allowance of traveling expenses as deductions in determining adjusted gross income, see section 62(2)(B) and the regulations thereunder.

(b) (1) If a taxpayer travels to a destination and while at such destination engages in both business and personal activities, traveling expenses to and from such destination are deductible only if the trip is related primarily to the taxpayer's trade or business. If the trip is primarily personal in nature, the traveling expenses to and from the destination are not deductible even though the taxpayer engages in business activities while at such destination. However, expenses while at the destination which are properly allocable to the taxpayer's trade or business are deductible even though the traveling expenses to and from the destination are not deductible.

(2) Whether a trip is related primarily to the taxpayer's trade or business or is primarily personal in nature depends on the facts and circumstances in each case. The amount of time during the period of the trip which is spent on personal activity compared to the amount of time spent on activities directly relating to the taxpayer's trade or business is an important factor in determining whether the trip is primarily personal. If, for example, a taxpayer spends one week while at a destination on activities which are directly related to his trade or business and subsequently spends an additional five weeks for vacation or other personal activities, the trip will be considered primarily personal in nature in the absence of a clear showing to the contrary.

(c) Where a taxpayer's wife accompanies him on a business trip, expenses attributable to her travel are not deductible unless it can be adequately shown that the wife's presence on the trip has a bona fide business purpose. The wife's performance of some incidental service does not cause her expenses to qualify as deductible business expenses. The same rules apply to any other members of the taxpayer's family who accompany him on such a trip.

(d) Expenses paid or incurred by a taxpayer in attending a convention or other meeting may constitute an ordinary and necessary business expense under section 162 depending upon the facts and circumstances of each case. No distinction will be made between self-employed persons and employees. The fact that an employee uses vacation or leave time or that his attendance at the convention is voluntary will not necessarily prohibit the allowance of the deduction. The allowance of deductions for such expenses will depend upon whether there is a sufficient relationship between the taxpayer's trade of business and his attendance at the convention or other meeting so that he is benefiting or advancing the interests of his trade or business by such attendance. If the convention is for political, social or other purposes unrelated to the taxpayer's trade or business, the expenses are not deductible.

(e) Commuters' fares are not considered as business expenses and are not deductible.

(f) For rules with respect to the reporting and substantiation of traveling and other business expenses of employees for taxable years beginning after December 31, 1957, see § 1.162-17.

§ 1.162-3 Cost of materials.

Taxpayers carrying materials and supplies on hand should include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operation during the taxable year for

which the return is made, provided that the costs of such materials and supplies have not been deducted in determining the net income or loss or taxable income for any previous year. If a taxpayer carries incidental materials or supplies on hand for which no record of consumption is kept or of which physical inventories at the beginning and end of the year are not taken, it will be permissible for the taxpayer to include in his expenses and to deduct from gross income the total cost of such supplies and materials as were purchased during the taxable year for which the return is made, provided the taxable income is clearly reflected by this method.

§ 1.162-4 Repairs.

The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with section 167 or charged against the depreciation reserve if such an account is kept.

§ 1.162-5 Expenses for education.

(a) *General rule.* Expenditures made by an individual for education (including research undertaken as part of his educational program) which are not expenditures of a type described in paragraph (b) (2) or (3) of this section are deductible as ordinary and necessary business expenses (even though the education may lead to a degree) if the education—

(1) Maintains or improves skills required by the individual in his employment or other trade or business, or

(2) Meets the express requirements of the individual's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation.

(b) *Nondeductible educational expenditures*—(1) *In general.* Educational expenditures described in subparagraphs (2) and (3) of this paragraph are personal expenditures or constitute an inseparable aggregate of personal and capital expenditures and, therefore, are not deductible as ordinary and necessary business expenses even though the education may maintain or improve skills required by the individual in his employment or other trade or business or may meet the express requirements of the individual's employer or of applicable law or regulations.

(2) *Minimum educational requirements.* (i) The first category of nondeductible educational expenses within the scope of subparagraph (1) of this paragraph are expenditures made by an individual for education which is required of him in order to meet the minimum educational requirements for qualification in his employment or other trade or business. The minimum education necessary to qualify for a position or other trade or business must be determined from a consideration of such factors as the requirements of the employer, the applicable law and regulations, a. ' the standards of the profession, trade, or business involved. The fact that an individual is already performing service in an employment status does not establish that he has met the minimum educational requirements for qualification in that employment. Once an individual has met the minimum educational requirements for qualification in his employment or other trade or business (as in effect when he enters the employment or trade or business), he shall be treated as continuing to meet those requirements even though they are changed.

(ii) The minimum educational requirements for qualification of a particular individual in a position in an educational institution is the minimum level of education (in terms of aggregate college hours or degree) which under the applicable laws or regulations, in effect at the time this individual is first employed in such position, is normally required of an indi-

vidual initially being employed in such a position. If there are no normal requirements as to the minimum level of education required for a position in an educational institution, then an individual in such a position shall be considered to have met the minimum educational requirements for qualification in that position when he becomes a member of the faculty of the educational institution. The determination of whether an individual is a member of the faculty of an educational institution must be made on the basis of the particular practices of the institution. However, an individual will ordinarily be considered to be a member of the faculty of an institution if (*a*) he has tenure or his years of service are being counted toward obtaining tenure; (*b*) the institution is making contributions to a retirement plan (other than Social Security or a similar program) in respect of his employment; or (*c*) he has a vote in faculty affairs.

(iii) The application of this subparagraph may be illustrated by the following examples:

Example (1). General facts: State X requires a bachelor's degree for beginning secondary school teachers which must include 30 credit hours of professional educational courses. In addition, in order to retain his position, a secondary school teacher must complete a fifth year of preparation within 10 years after beginning his employment. If an employing school official certifies to the State Department of Education that applicants having a bachelor's degree and the required courses in professional education cannot be found, he may hire individuals as secondary school teachers if they have completed a minimum of 90 semester hours of college work. However, to be retained in his position, such an individual must obtain his bachelor's degree and complete the required professional educational courses within 3 years after his employment commences. Under these facts, a bachelor's degree, without regard to whether it includes 30 credit hours of professional educational courses, is considered to be the minimum educational requirement for qualification as a secondary school teacher in State X. This is the case notwithstanding the number of teachers who are actually hired without such a degree. The following are examples of the application of these facts in particular situations:

Situation 1. A, at the time he is employed as a secondary school teacher in State X, has a bachelor's degree including 30 credit hours of professional educational courses. After his employment, A completes a fifth college year of education and, as a result, is issued a standard certificate. The fifth college year of education undertaken by A is not education required to meet the minimum educational requirements for qualification as a secondary school teacher. Accordingly, the expenditures for such education are deductible unless the expenditures are for education which is part of a program of study being pursued by A which will lead to qualifying him in a new trade or business.

Situation 2. Because of a shortage of applicants meeting the stated requirements, B, who has a bachelor's degree, is employed as a secondary school teacher in State X even though he has only 20 credit hours of professional educational courses. After his employment, B takes an additional 10 credit hours of professional educational courses. Since these courses do not constitute education required to meet the minimum educational requirements for qualification as a secondary school teacher which is a bachelor's degree and will not lead to qualifying B in a new trade or business, the expenditures for such courses are deductible.

Situation 3. Because of a shortage of applicants meeting the stated requirements, C is employed as a secondary school teacher in State X although he has only 90 semester hours of college work toward his bachelor's degree. After his employment, C undertakes courses leading to a bachelor's degree. These courses (including any courses in professional education) constitute education required to meet the minimum educational requirements for qualification as a secondary school teacher. Accordingly, the expenditures for such education are not deductible.

Situation 4. Subsequent to the employment of A, B, and C, but before they have completed a fifth college year of education, State X changes its requirements affecting secondary school teachers to provide that beginning teachers must have completed 5 college years of preparation. In the cases of A, B, and C, a fifth college year of education is not considered to be education undertaken to meet the minimum educational requirements for qualifications as a secondary school teacher. Accordingly, expenditures for a fifth year of college will be deductible unless the expenditures are for education which is part of a program being pursued by A, B, or C which will lead to qualifying him in a new trade or business.

Example (2). D, who holds a bachelor's degree, obtains temporary employment as an instructor at University Y and undertakes graduate courses as a candidate for a graduate degree. D may become a faculty member only if he obtains a graduate degree and may continue to hold a position

as instructor only so long as he shows satisfactory progress towards obtaining this graduate degree. The graduate courses taken by D constitute education required to meet the minimum educational requirements for qualification in D's trade or business and, thus, the expenditures for such courses are not deductible.

Example (3). E, who has completed 2 years of a normal 3-year law school course leading to a bachelor of laws degree (LL.B.), is hired by a law firm to do legal research and perform other functions on a full-time basis. As a condition to continued employment, E is required to obtain an LL.B. and pass the State bar examination. E completes his law school education by attending night law school, and he takes a bar review course in order to prepare for the State bar examination. The law courses and bar review course constitute education required to meet the minimum educational requirements for qualification in E's trade or business and, thus, the expenditures for such courses are not deductible.

(3) *Qualification for new trade or business.* (i) The second category of nondeductible educational expenses within the scope of subparagraph (1) of this paragraph are expenditures made by an individual for education which is part of a program of study being pursued by him which will lead to qualifying him in a new trade or business. In the case of an employee, a change of duties does not constitute a new trade or business if the new duties involve the same general type of work as is involved in the individual's present employment. For this purpose, all teaching and related duties shall be considered to involve the same general type of work. The following are examples of changes in duties which do not constitute new trades or businesses:

(*a*) Elementary to secondary school classroom teacher.

(*b*) Classroom teacher in one subject (such as mathematics) to classroom teacher in another subject (such as science).

(*c*) Classroom teacher to guidance counselor.

(*d*) Classroom teacher to principal.

(ii) The application of this subparagraph to individuals other than teachers may be illustrated by the following examples:

Example (1). A, a self-employed individual practicing a profession other than law, for example, engineering, accounting, etc., attends law school at night and after completing his law school studies receives a bachelor of laws degree. The expenditures made by A in attending law school are nondeductible because this course of study qualifies him for a new trade or business.

Example (2). Assume the same facts as in example (1) except that A has the status of an employee rather than a self-employed individual, and that his employer requires him to obtain a bachelor of laws degree. A intends to continue practicing his nonlegal profession as an employee of such employer. Nevertheless, the expenditures made by A in attending law school are not deductible since this course of study qualifies him for a new trade or business.

Example (3). B, a general practitioner of medicine, takes a 2-week course reviewing new developments in several specialized fields of medicine. B's expenses for the course are deductible because the course maintains or improves skills required by him in his trade or business and does not qualify him for a new trade or business.

Example (4). C, while engaged in the private practice of psychiatry, undertakes a program of study and training at an accredited psychoanalytic institute which will lead to qualifying him to practice psychoanalysis. C's expenditures for such study and training are deductible because the study and training maintains or improves skills required by him in his trade or business and does not qualify him for a new trade or business.

(c) *Deductible educational expenditures*—(1) *Maintaining or improving skills.* The deduction under the category of expenditures for education which maintains or improves skills required by the individual in his employment or other trade or business includes refresher courses or courses dealing with current developments as well as academic or vocational courses provided the expenditures for the courses are not within either category of nondeductible expenditures described in paragraph (b) (2) or (3) of this section.

(2) *Meeting requirements of employer.* An individual is considered to have undertaken education in order to meet the express requirements of his employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the taxpayer of his established employment relationship, status, or rate of compensation only if such requirements are imposed for a bona fide business pur-

pose of the individual's employer. Only the minimum education necessary to the retention by the individual of his established employment relationship, status, or rate of compensation may be considered as undertaken to meet the express requirements of the taxpayer's employer. However, education in excess of such minimum education may qualify as education undertaken in order to maintain or improve the skills required by the taxpayer in his employment or other trade or business (see subparagraph (1) of this paragraph). In no event, however, is a deduction allowable for expenditures for education which, even though for education required by the employer or applicable law or regulations, are within one of the categories of nondeductible expenditures described in paragraph (b) (2) and (3) of this section.

(d) *Travel as a form of education.* Subject to the provisions of paragraph (b) and (e) of this section, expenditures for travel (including travel while on sabbatical leave) as a form of education are deductible only to the extent such expenditures are attributable to a period of travel that is directly related to the duties of the individual in his employment or other trade or business. For this purpose, a period of travel shall be considered directly related to the duties of an individual in his employment or other trade or business only if the major portion of the activities during such period is of a nature which directly maintains or improves skills required by the individual in such employment or other trade or business. The approval of a travel program by an employer or the fact that travel is accepted by an employer in the fulfillment of its requirements for retention of rate of compensation, status or employment, is not determinative that the required relationship exists between the travel involved and the duties of the individual in his particular position.

(e) *Travel away from home.* (1) If an individual travels away from home primarily to obtain education the expenses of which are deductible under this section, his expenditures for travel, meals, and lodging while away from home are deductible. However, if as an incident of such trip the individual engages in some personal activity such as sightseeing, social visiting, or entertaining, or other recreation, the portion of the expenses attributable to such personal activity constitutes nondeductible personal or living expenses and is not allowable as a deduction. If the individual's travel away from home is primarily personal, the individual's expenditures for travel, meals and lodging (other than meals and lodging during the time spent in participating in deductible education pursuits) are not deductible. Whether a particular trip is primarily person or primarily to obtain education the expenses of which are deductible under this section depends upon all the facts and circumstances of each case. An important factor to be taken into consideration in making the determination is the relative amount of time devoted to personal activity as compared with the time devoted to educational pursuits. The rules set forth in this paragraph are subject to the provisions of section 162(a)(2), relating to deductibility of certain traveling expenses, and section 274 (c) and (d), relating to allocation of certain foreign travel expenses and substantiation required, respectively, and the regulations thereunder.

(2) *Examples.* The application of this subsection may be illustrated by the following examples:

Example (1). A, a self-employed tax practitioner, decides to take a 1-week course in new developments in taxation, which is offered in City X, 500 miles away from his home. His primary purpose in going to X is to take the course, but he also takes a side trip to City Y (50 miles from X) for 1 day, takes a sightseeing trip while in X, and entertains some personal friends. A's transportation expenses to City X and return to his home are deductible but his transportation expenses to City Y are not deductible. A's expenses for meals and lodging while away from home will be allocated between his educational pursuits and his personal activities. Those expenses which are entirely personal, such as sightseeing and entertaining friends, are not deductible to any extent.

Example (2). The facts are the same as in example (1) except that A's primary purpose in going to City X is to take a vacation. This purpose is indicated by several factors, one of which is the fact that he spends only 1 week attending the tax course and devotes 5 weeks entirely to personal activities. None

of A's transportation expenses are deductible and his expenses for meals and lodging while away from home are not deductible to the extent attributable to personal activities. His expenses for meals and lodging allocable to the week attending the tax course are, however, deductible.

Example (3). B, a high school mathematics teacher in New York City, in the summertime travels to a university in California in order to take a mathematics course the expense of which is deductible under this section. B pursues only one-fourth of a full course of study and the remainder of her time is devoted to personal activities the expense of which is not deductible. Absent a showing by B of a substantial nonpersonal reason for taking the course in the university in California, the trip is considered taken primarily for personal reasons and the cost of traveling from New York City to California and return would not be deductible. However, one-fourth of the cost of B's meals and lodging while attending the university in California may be considered properly allocable to deductible educational pursuits and, therefore, is deductible.

[T.D. 6918, 32 FR 6679, May 2, 1967]

§ 1.162-6 Professional expenses.

A professional man may claim as deductions the cost of supplies used by him in the practice of his profession, expenses paid or accrued in the operation and repair of an automobile used in making professional calls, dues to professional societies and subscriptions to professional journals, the rent paid or accrued for office rooms, the cost of the fuel, light, water, telephone, etc., used in such offices, and the hire of office assistance. Amounts currently paid or accrued for books, furniture, and professional instruments and equipment, the useful life of which is short, may be deducted.

§ 1.162-7 Compensation for personal services.

(a) There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

(b) The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true com-

pensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

(4) For disallowance of deduction in the case of certain transfers of stock pursuant to employees stock options, see section 421 and the regulations thereunder.

§ 1.162-8 Treatment of excessive compensation.

The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stockholdings, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend. If such payments constitute payment for property, they should be treated by the payor as a capital expenditure and by the recipient as part of the purchase price. In the absence of evidence to justify other treatment, excessive payments for salaries or other compensation for personal services will be included in gross income of the recipient.

§ 1.162-9 Bonuses to employees.

Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or which are in excess of reasonable compensation for services, are not deductible from gross income.

§ 1.162-10 Certain employee benefits.

(a) *In general.* Amounts paid or accrued by a taxpayer on account of injuries received by employees and lumpsum amounts paid or accrued as compensation for injuries, are proper deductions as ordinary and necessary expenses. Such deductions are limited to the amount not compensated for by insurance or otherwise. Amounts paid or accrued within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plan, are deductible under section 162(a) if they are ordinary and necessary expenses of the trade or business. However, except as provided in paragraph (b) of this section, such amounts shall not be deductible under section 162(a) if, under any circumstances, they may be used to provide benefits under a stock bonus, pension, annuity, profit-sharing, or other deferred compensation plan of the type referred to in section 404(a). In such an event, the extent to which these amounts are deductible from gross income shall be governed by the provisions of section 404 and the regulations issued thereunder.

(b) *Certain negotiated plans.* (1) Subject to the limitations set forth in subparagraphs (2) and (3) of this paragraph, contributions paid by an employer under a plan under which such contributions are held in a welfare trust for the purpose of paying (either from principal or income or both) for the benefit of employees, their families, and dependents, at least medical or hospital care, and pensions on retirement or death of employees, are deductible when paid as business expenses under section 162(a).

(2) For the purpose of subparagraph (1) of this paragraph, the word "plan" means any plan established prior to January 1, 1954, as a result of an agreement between employee representatives and the Government of the United States, during a period of Government operation, under seizure powers, of a major part of the productive facilities of the industry in which the employer claiming the deduction is engaged. The phrase "plan estab-

lished prior to January 1, 1954, as a result of an agreement" is intended primarily to cover a trust established under the terms of such an agreement. It also includes a trust established under a plan of an employer, or group of employers, who, by reason of producing the same commodity, are in competition with the employers whose facilities were seized and who would therefore be expected to establish such a trust as a reasonable measure to maintain a sound position in the labor market producing the commodity. For example, if a trust was established under such an agreement in the bituminous coal industry, a similar trust established in the anthracite coal industry within a reasonable time, but before January 1, 1954, would qualify under subparagraph (1) of this paragraph.

(3) If any trust described in subparagraph (2) of this paragraph becomes qualified for exemption from tax under the provisions of section 501(a), the deductibility of contributions by an employer to such trust on or after any date of such qualification shall no longer be governed by the provisions of section 162, even though the trust may later lose its exemption from tax under section 501(a).

(c) *Other plans providing deferred compensation.* For rules relating to the deduction of amounts paid to or under a stock bonus, pension, annuity, or profit-sharing plan or amounts paid or accrued under any other plan deferring the receipt of compensation, see section 404 and the regulations thereunder.

§ 1.162-11 Rentals.

(a) *Acquisition of a leasehold.* If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. For disallowance of deduction for income taxes paid by a lessee corporation pursuant to a lease arrangement with the lessor corporation, see section 110 and the regulations thereunder. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in amortizing the costs incurred after July 28, 1958 of acquiring a lease.

(b) *Improvements by lessee on lessor's property.* (1) The cost to a lessee of erecting buildings or making permanent improvements on property of which he is the lessee is a capital investment, and is not deductible as a business expense. If the estimated useful life in the hands of the taxpayer of the building erected or of the improvements made, determined without regard to the terms of the lease, is longer than the remaining period of the lease, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining in the term of the lease, and such deduction shall be in lieu of a deduction for depreciation. If, on the other hand, the useful life of such buildings or improvements in the hands of the taxpayer is equal to or shorter than the remaining period of the lease, this deduction shall be computed under the provisions of section 167 (relating to depreciation).

(2) If the lessee began improvements on leased property before July 28, 1958, or if the lessee was on such date and at all times thereafter under a binding legal obligation to make such improvements, the matter of spreading the cost of erecting buildings or making permanent improvements over the term of the original lease, together with the renewal period or periods depends upon the facts in the particular case, including the presence or absence of an obligation of renewal and the relationship between the parties. As a general rule, unless the lease has been renewed or the facts show with reasonable certainty that the lease will be renewed, the cost or other basis of the lease, or the cost of improvements shall be spread only over the number of years the lease has to run without taking into account any right of renewal. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). A subsidiary corporation leases land from its parent at a fair rental for a 25-year period. The subsidiary erects on the land valuable factory buildings having an estimated useful life of 50 years. These facts show with reasonable certainty that the lease will be renewed, even though the lease contains no option of renewal. Therefore, the cost of the buildings shall be depreciated over the estimated useful life of the buildings in accordance with section 167 and the regulations thereunder.

Example (2). A retail merchandising corporation leases land at a fair rental from an unrelated lessor for the longest period that the lessor is willing to lease the land (30 years). The lessee erects on the land a department store having an estimated useful life of 40 years. These facts do not show with reasonable certainty that the lease will be renewed. Therefore, the cost of the building shall be spread over the remaining term of the lease. An annual deduction may be made of an amount equal to the cost of the building divided by the number of years remaining in the term of the lease, and such deduction shall be in lieu of a deduction for depreciation.

(3) See section 178 and the regulations thereunder for rules governing the effect to be given renewal options where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such date and at all times thereafter, the lessee was under a binding legal obligation to make.

[T.D. 6520, 25 FR 13692, Dec. 24, 1960]

§ 1.162-12 Expenses of farmers.

(a) *Farms engaged in for profit.* A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may be deducted. The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. For taxable years beginning after July 12, 1972, where a farmer is engaged in producing crops and the process of gathering and disposal of such crops is not completed within the taxable year in which such crops were planted, expenses deducted may, with the consent of the Commissioner (see section 446 and the regulations thereunder), be determined upon the crop method, and such deductions must be taken in the taxable year in which the gross income from the crop has been realized. For taxable years beginning on or before July 12, 1972, where a farmer is engaged in producing crops which take more than a year from the time of planting to the process of gathering and disposal, expenses deducted may, with the consent of the Commissioner (see section 446 and the regulations thereunder), be determined upon the crop method, and such deductions must be taken in the taxable year in which the gross income from the crop has been realized. If a farmer does not compute income upon the crop method, the cost of seeds and young plants which are purchased for further development and cultivation prior to sale in later years may be deducted as an expense for the year of purchase, provided the farmer follows a consistent practice of deducting such costs as an expense from year to year. The preceding sentence does not apply to the cost of seeds and young plants connected with the planting of timber (see section 611 and the regulations thereunder). For provisions relating to citrus and almond groves, see section 278 and the regulations thereunder. The cost of farm machinery, equipment, and farm buildings represents a capital investment and is not an allowable deduction as an item of expense. Amounts expended in the development of farms, orchards, and ranches prior to the time when the productive state is reached may, at the election of the taxpayer, be regarded as investments of capital. For the treatment of soil and water conservation expenditures as expenses which are not chargeable to capital account, see section 175 and the regulations thereunder. For taxable years beginning after December 31, 1959, in the case of expenditures paid or incurred by farmers for fertilizer, lime, etc., see section 180 and the regulations thereunder. Amounts expended in purchasing work, breeding, dairy, or sporting animals are regarded as investments of

capital, and shall be depreciated unless such animals are included in an inventory in accordance with § 1.61-4. The purchase price of an automobile, even when wholly used in carrying on farming operations, is not deductible, but is regarded as an investment of capital. The cost of gasoline, repairs, and upkeep of an automobile if used wholly in the business of farming is deductible as an expense; if used partly for business purposes and partly for the pleasure or convenience of the taxpayer or his family, such cost may be apportioned according to the extent of the use for purposes of business and pleasure or convenience, and only the proportion of such cost justly attributable to business purposes is deductible as a necessary expense.

(b) *Farms not engaged in for profit; taxable years beginning before January 1, 1970*—(1) *In general.* If a farm is operated for recreation or pleasure and not on a commercial basis, and if the expenses incurred in connection with the farm are in excess of the receipts therefrom, the entire receipts from the sale of farm products may be ignored in rendering a return of income, and the expenses incurred, being regarded as personal expenses, will not constitute allowable deductions.

(2) *Effective date.* The provisions of this paragraph shall apply with respect to taxable years beginning before January 1, 1970.

(3) *Cross reference.* For provisions relating to activities not engaged in for profit, applicable to taxable years beginning after December 31, 1969, see section 183 and the regulations thereunder.

[T.D. 7198, 37 FR 13679, July 13, 1972]

§ 1.162-13 Depositors' guaranty fund.

Banking corporations which pursuant to the laws of the State in which they are doing business are required to set apart, keep, and maintain in their banks the amount levied and assessed against them by the State authorities as a "Depositors' guaranty fund," may deduct from their gross income the amount so set apart each year to this fund provided that such fund, when set aside and carried to the credit of the State banking board or duly authorized State officer, ceases to be an asset of the bank and may be withdrawn in whole or in part upon demand by such board or State officer to meet the needs of these officers in reimbursing depositors in insolvent banks, and provided further that no portion of the amount thus set aside and credited is returnable under the laws of the State to the assets of the banking corporation. If, however, such amount is simply set up on the books of the bank as a reserve to meet a contingent liability and remains an asset of the bank, it will not be deductible except as it is actually paid out as required by law and upon demand of the proper State officers.

§ 1.162-14 Expenditures for advertising or promotion of good will.

A corporation which has, for the purpose of computing its excess profits tax credit under subchapter E, chapter 2, or subchapter D, chapter 1 of the Internal Revenue Code of 1939, elected under section 733 or section 451 (applicable to the excess profits tax imposed by subchapter E of chapter 2, and subchapter D of chapter 1, respectively) to charge to capital account for taxable years in its base period expenditures for advertising or the promotion of good will which may be regarded as capital investments, may not deduct similar expenditures for the taxable year. See section 263(b). Such a taxpayer has the burden of proving that expenditures for advertising or the promotion of good will which it seeks to deduct in the taxable year may not be regarded as capital investments under the provisions of the regulations prescribed under section 733 or section 451 of the Internal Revenue Code of 1939. See 26 CFR, 1938 ed., 35.733-2 (Regulations 112) and 26 CFR (1939) 40.451-2 (Regulations 130). For the disallowance of deductions for the cost of advertising in programs of certain conventions of political parties, or in publications part of the proceeds of which directly or indirectly inures (or is intended to inure) to or for the use of a political party or political candidate, see § 1.276-1.

[T.D. 6996, 34 FR 835, Jan. 18, 1969]

§ 1.162-15 Contributions, dues, etc.

(a) *Contributions to organizations described in section 170—*(1) *In general.* No deduction is allowable under section 162(a) for a contribution or gift by an individual or a corporation if any part thereof is deductible under section 170. For example, if a taxpayer makes a contribution of $5,000 and only $4,000 of this amount is deductible under section 170(a) (whether because of the percentage limitation under either section 170(b) (1) or (2), the requirement as to time of payment, or both) no deduction is allowable under section 162(a) for the remaining $1,000.

(2) *Scope of limitations.* The limitations provided in section 162(b) and this paragraph apply only to payments which are in fact contributions or gifts to organizations described in section 170. For example, payments by a transit company to a local hospital (which is a charitable organization within the meaning of section 170) in consideration of a binding obligation on the part of the hospital to provide hospital services and facilities for the company's employees are not contributions or gifts within the meaning of section 170 and may be deductible under section 162(a) if the requirements of section 162(a) are otherwise satisfied.

(b) *Other contributions.* Donations to organizations other than those described in section 170 which bear a direct relationship to the taxpayer's business and are made with a reasonable expectation of a financial return commensurate with the amount of the donation may constitute allowable deductions as business expenses, provided the donation is not made for a purpose for which a deduction is not allowable by reason of the provisions of paragraph (b)(1)(i) or (c) of § 1.162-20. For example, a transit company may donate a sum of money to an organization (of a class not referred to in section 170) intending to hold a convention in the city in which it operates, with a reasonable expectation that the holding of such convention will augment its income through a greater number of people using its transportation facilities.

(c) *Dues.* Dues and other payments to an organization, such as a labor union or a trade association, which otherwise meet the requirements of the regulations under section 162, are deductible in full. For limitations on the deductibility of dues and other payments, see paragraph (b) and (c) of § 1.162-20.

(d) *Cross reference.* For provisions dealing with expenditures for institutional or "good will" advertising, see § 1.162-20.

[T.D. 6819, 30 FR 5580, Apr. 20, 1965]

§ 1.162-16 Cross reference.

For special rules relating to expenses in connection with subdividing real property for sale, see section 1237 and the regulations thereunder.

§ 1.162-17 Reporting and substantiation of certain business expenses of employees.

(a) *Introductory.* The purpose of the regulations in this section is to provide rules for the reporting of information on income tax returns by taxpayers who pay or incur ordinary and necessary business expenses in connection with the performance of services as an employee and to furnish guidance as to the type of records which will be useful in compiling such information and in its substantiation, if required. The rules prescribed in this section do not apply to expenses paid or incurred for incidentals, such as office supplies for the employer or local transportation in connection with an errand. Employees incurring such incidental expenses are not required to provide substantiation for such amounts. The term "ordinary and necessary business expenses" means only those expenses which are ordinary and necessary in the conduct of the taxpayer's business and are directly attributable to such business. The term does not include nondeductible personal, living or family expenses.

(b) *Expenses for which the employee is required to account to his employer—*(1) *Reimbursements equal to expenses.* The employee need not report on his tax return (either itemized or in total amount) expenses for travel,

transportation, entertainment, and similar purposes paid or incurred by him solely for the benefit of his employer for which he is required to account and does account to his employer and which are charged directly or indirectly to the employer (for example, through credit cards) or for which the employee is paid through advances, reimbursements, or otherwise, provided the total amount of such advances, reimbursements, and charges is equal to such expenses. In such a case the taxpayer need only state in his return that the total of amounts charged directly or indirectly to his employer through credit cards or otherwise and received from the employer as advances or reimbursements did not exceed the ordinary and necessary business expenses paid or incurred by the employee.

(2) *Reimbursements in excess of expenses.* In case the total of amounts charged directly or indirectly to the employer and received from the employer as advances, reimbursements, or otherwise, exceeds the ordinary and necessary business expenses paid or incurred by the employee and the employee is required to and does account to his employer for such expenses, the taxpayer must include such excess in income and state on his return that he has done so.

(3) *Expenses in excess of reimbursements.* If the employee's ordinary and necessary business expenses exceed the total of the amounts charged directly or indirectly to the employer and received from the employer as advances, reimbursements, or otherwise, and the employee is required to and does account to his employer for such expenses, the taxpayer may make the statement in his return required by subparagraph (1) of this paragraph unless he wishes to claim a deduction for such excess. If, however, he wishes to secure a deduction for such excess, he must submit a statement showing the following information as part of his tax return:

(i) The total of any charges paid or borne by the employer and of any other amounts received from the employer for payment of expenses whether by means of advances, reimbursements or otherwise; and

(ii) The nature of his occupation, the number of days away from home on business, and the total amount of ordinary and necessary business expenses paid or incurred by him (including those charged directly or indirectly to the employer through credit cards or otherwise) broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses.

(4) To "account" to his employer as used in this section means to submit an expense account or other required written statement to the employer showing the business nature and the amount of all the employee's expenses (including those charged directly or indirectly to the employer through credit cards or otherwise) broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses. For this purpose, the Commissioner in his discretion may approve reasonable business practices under which mileage, per diem in lieu of subsistence, and similar allowances providing for ordinary and necessary business expenses in accordance with a fixed scale may be regarded as equivalent to an accounting to the employer.

(c) *Expenses for which the employee is not required to account to his employer.* If the employee is not required to account to his employer for his ordinary and necessary business expenses, e.g., travel, transportation, entertainment, and similar items, or, though required, fails to account for such expenses, he must submit, as a part of his tax return, a statement showing the following information:

(1) The total of all amounts received as advances or reimbursements from his employer in connection with the ordinary and necessary business expenses of the employee, including amounts charged directly or indirectly to the employer through credit cards or otherwise; and

(2) The nature of his occupation, the number of days away from home on business, and the total amount of ordinary and necessary business expenses paid or incurred by him (including those charged directly or indirectly to

the employer through credit cards or otherwise) broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses.

(d) *Substantiation of items of expense.* (1) Although the Commissioner may require any taxpayer to substantiate such information concerning expense accounts as may appear to be pertinent in determining tax liability, taxpayers ordinarily will not be called upon to substantiate expense account information except those in the following categories:

(i) A taxpayer who is not required to account to his employer, or who does not account;

(ii) A taxpayer whose expenses exceed the total of amounts charged to his employer and amounts received through advances, reimbursements or otherwise and who claims a deduction on his return for such excess;

(iii) A taxpayer who is related to his employer within the meaning of section 267(b); and

(iv) Other taxpayers in cases where it is determined that the accounting procedures used by the employer for the reporting and substantiation of expenses by employees are not adequate.

(2) The Code contemplates that taxpayers keep such records as will be sufficient to enable the Commissioner to correctly determine income tax liability. Accordingly, it is to the advantage of taxpayers who may be called upon to substantiate expense account information to maintain as adequate and detailed records of travel, transportation, entertainment, and similar business expenses as practical since the burden of proof is upon the taxpayer to show that such expenses were not only paid or incurred but also that they constitute ordinary and necessary business expenses. One method for substantiating expenses incurred by an employee in connection with his employment is through the preparation of a daily diary or record of expenditures, maintained in sufficient detail to enable him to readily identify the amount and nature of any expenditure, and the preservation of supporting documents, especially in connection with large or exceptional expenditures. Nevertheless, it is recognized that by reason of the nature of certain expenses or the circumstances under which they are incurred, it is often difficult for an employee to maintain detailed records or to preserve supporting documents for all his expenses. Detailed records of small expenditures incurred in traveling or for transportation, as for example, tips, will not be required.

(3) Where records are incomplete or documentary proof is unavailable, it may be possible to establish the amount of the expenditures by approximations based upon reliable secondary sources of information and collateral evidence. For example, in connection with an item of traveling expense a taxpayer might establish that he was in a travel status a certain number of days but that it was impracticable for him to establish the details of all his various items of travel expense. In such a case rail fares or plane fares can usually be ascertained with exactness and automobile costs approximated on the basis of mileage covered. A reasonable approximation of meals and lodging might be based upon receipted hotel bills or upon average daily rates for such accommodations and meals prevailing in the particular community for comparable accommodations. Since detailed records of incidental items are not required, deductions for these items may be based upon a reasonable approximation. In cases where a taxpayer is called upon to substantiate expense account information, the burden is on the taxpayer to establish that the amounts claimed as a deduction are reasonably accurate and constitute ordinary and necessary business expenses paid or incurred by him in connection with his trade or business. In connection with the determination of factual matters of this type, due consideration will be given to the reasonableness of the stated expenditures for the claimed purposes in relation to the taxpayer's circumstances (such as his income and the nature of his occupation), to the reliability and accuracy of records in connection with other items more readily lending themselves to detailed recordkeeping, and to all of the

facts and circumstances in the particular case.

(e) *Applicability.* (1) Except as provided in subparagraph (2) of this paragraph, the provisions of the regulations in this section are supplemental to existing regulations relating to information required to be submitted with income tax returns, and shall be applicable with respect to taxable years beginning after December 31, 1957, notwithstanding any existing regulation to the contrary.

(2) With respect to taxable years ending after December 31, 1962, but only in respect of periods after such date, the provisions of the regulations in this section are superseded by the regulations under section 274(d) to the extent inconsistent therewith. See § 1.274-5.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6630, 27 FR 12935, Dec. 29, 1962]

§ 1.162-18 Illegal bribes and kickbacks.

(a) *Illegal payments to government officials or employees*—(1) *In general.* No deduction shall be allowed under section 162(a) for any amount paid or incurred, directly or indirectly, to an official or employee of any government, or of any agency or other instrumentality of any government, if—

(i) In the case of a payment made to an official or employee of a government other than a foreign government described in subparagraph (3) (ii) or (iii) of this paragraph, the payment constitutes an illegal bribe or kickback, or

(ii) In the case of a payment made to an official or employee of a foreign government described in subparagraph (3) (ii) or (iii) of this paragraph, the making of the payment would be unlawful under the laws of the United States (if such laws were applicable to the payment and to the official or employee at the time the expenses were paid or incurred).

No deduction shall be allowed for an accrued expense if the eventual payment thereof would fall within the prohibition of this section. The place where the expenses are paid or incurred is immaterial. For purposes of subdivision (ii) of this subparagraph, lawfulness, or unlawfulness of the payment under the laws of the foreign country is immaterial.

(2) *Indirect payment.* For purposes of this paragraph, an indirect payment to an individual shall include any payment which inures to his benefit or promotes his interests, regardless of the medium in which the payment is made and regardless of the identity of the immediate recipient or payor. Thus, for example, payment made to an agent, relative, or independent contractor of an official or employee, or even directly into the general treasury of a foreign country of which the beneficiary is an official or employee, may be treated as an indirect payment to the official or employee, if in fact such payment inures or will inure to his benefit or promotes or will promote his financial or other interests. A payment made by an agent or independent contractor of the taxpayer which benefits the taxpayer shall be treated as an indirect payment by the taxpayer to the official or employee.

(3) *Official or employee of a government.* Any individual officially connected with—

(i) The Government of the United States, a State, a territory or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico,

(ii) The government of a foreign country, or

(iii) A political subdivision of, or a corporation or other entity serving as an agency or instrumentality of, any of the above,

in whatever capacity, whether on a permanent or temporary basis, and whether or not serving for compensation, shall be included within the term "official or employee of a government", regardless of the place of residence or post of duty of such individual. An independent contractor would not ordinarily be considered to be an official or employee. For purposes of section 162(c) and this paragraph, the term "foreign country" shall include any foreign nation, whether or not such nation has been accorded diplomatic recognition by the United States. Individuals who purport to act on behalf of or as the government of a

foreign nation, or an agency or instrumentality thereof, shall be treated under this section as officials or employees of a foreign government, whether or not such individuals in fact control such foreign nation, agency, or instrumentality, and whether or not such individuals are accorded diplomatic recognition. Accordingly, a group in rebellion against an established government shall be treated as officials or employees of a foreign government, as shall officials or employees of the government against which the group is in rebellion.

(4) *Laws of the United States.* The term "laws of the United States", to which reference is made in paragraph (a)(1)(ii) of this section, shall be deemed to include only Federal statutes, including State laws which are assimilated into Federal law by Federal statute, and legislative and interpretative regulations thereunder. The term shall also be limited to statutes which prohibit some act or acts, for the violation of which there is a civil or criminal penalty.

(5) *Burden of proof.* In any proceeding involving the issue of whether, for purposes of section 162(c)(1), a payment made to a government official or employee constitutes an illegal bribe or kickback (or would be unlawful under the laws of the United States) the burden of proof in respect of such issue shall be upon the Commissioner to the same extent as he bears the burden of proof in civil fraud cases under section 7454 (i.e., he must prove the illegality of the payment by clear and convincing evidence).

(6) *Example.* The application of this paragraph may be illustrated by the following example:

Example. X Corp. is in the business of selling hospital equipment in State Y. During 1970, X Corp. employed A who at the time was employed full time by State Y as Superintendent of Hospitals. The purpose of A's employment by X Corp. was to procure for it an improper advantage over other concerns in the making of sales to hospitals in respect of which A, as Superintendent, had authority. X Corp. paid A $5,000 during 1970. The making of this payment was illegal under the laws of State Y. Under section 162(c)(1), X Corp. is precluded from deducting as a trade or business expense the $5,000 paid to A.

(b) *Other illegal payments*—(1) *In general.* No deduction shall be allowed under section 162(a) for any payment (other than a payment described in paragraph (a) of this section) made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under the laws of the United States (as defined in paragraph (a)(4) of this section), or under any State law (but only if such State law is generally enforced), which subjects the payor to a criminal penalty or the loss (including a suspension) of license or privilege to engage in a trade or business (whether or not such penalty or loss is actually imposed upon the taxpayer). For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer. This paragraph applies only to payments made after December 30, 1969.

(2) *State law.* For purposes of this paragraph, State law means a statute of a State or the District of Columbia.

(3) *Generally enforced.* For purposes of this paragraph, a State law shall be considered to be generally enforced unless it is never enforced or the only persons normally charged with violations thereof in the State (or the District of Columbia) enacting the law are infamous or those whose violations are extraordinarily flagrant. For example, a criminal statute of a State shall be considered to be generally enforced unless violations of the statute which are brought to the attention of appropriate enforcement authorities do not result in any enforcement action in the absence of unusual circumstances.

(4) *Burden of proof.* In any proceeding involving the issue of whether, for purposes of section 162(c)(2), a payment constitutes an illegal bribe, illegal kickback, or other illegal payment the burden of proof in respect of such issue shall be upon the Commissioner to the same extent as he bears the burden of proof in civil fraud cases under section 7454 (i.e., he must prove the illegality of the payment by clear and convincing evidence).

(5) *Example.* The application of this paragraph may be illustrated by the following example:

Example. X Corp., a calendar-year taxpayer, is engaged in the ship repair business in State Y. During 1970, repairs on foreign ships accounted for a substantial part of its total business. It was X Corp.'s practice to kick back approximately 10 percent of the repair bill to the captain and chief engineer of all foreign-owned vessels, which kickbacks are illegal under a law of State Y (which is generally enforced) and potentially subject X Corp. to fines. During 1970, X Corp. paid $50,000 in such kickbacks. On X Corp.'s return for 1970, a deduction under section 162 was taken for the $50,000. The deduction of the $50,000 of illegal kickbacks during 1970 is disallowed under section 162(c)(2), whether or not X Corp. is prosecuted with respect to the kickbacks.

(c) *Kickbacks, rebates, and bribes under medicare and medicaid.* No deduction shall be allowed under section 162(a) for any kickback, rebate, or bribe (whether or not illegal) made on or after December 10, 1971, by any provider of services, supplier, physician, or other person who furnishes items or services for which payment is or may be made under the Social Security Act, as amended, or in whole or in part out of Federal funds under a State plan approved under such Act, if such kickback, rebate, or bribe is made in connection with the furnishing of such items or services or the making or receipt of such payments. For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer.

[T.D. 7345, 40 FR 7437, Feb. 20, 1975; 40 FR 8948, Mar. 4, 1975]

§ 1.162-19 Capital contributions to Federal National Mortgage Association.

(a) *In general.* The initial holder of stock of the Federal National Mortgage Association (FNMA) which is issued pursuant to section 303(c) of the Federal National Mortgage Association Charter Act (12 U.S.C., sec. 1718) in a taxable year beginning after December 31, 1959, shall treat the excess, if any, of the issuance price (the amount of capital contributions evidenced by a share of stock) over the fair market value of the stock as of the issue date of such stock as an ordinary and necessary business expense paid or incurred during the year in which occurs the date of issuance of the stock. To the extent that a sale to FNMA of mortgage paper gives rise to the issuance of a share of FNMA stock during a taxable year beginning after December 31, 1959, such sale is to be treated in a manner consistent with the purpose for, and the legislative intent underlying the enactment of, the provisions of section 8, Act of September 14, 1960 (Public Law 86-779, 74 Stat. 1003). Thus, for the purpose of determining an initial holder's gain or loss from the sale to FNMA of mortgage paper, with respect to which a share of FNMA stock is issued in a taxable year beginning after December 31, 1959 (irrespective of when the sale is made), the amount realized by the initial holder from the sale of the mortgage paper is the amount of the "FNMA purchase price". The "FNMA purchase price" is the gross amount of the consideration agreed upon between FNMA and the initial holder for the purchase of the mortgage paper, without regard to any deduction therefrom as, for example, a deduction representing a capital contribution or a purchase or marketing fee. The date of issuance of the stock is the date which appears on the stock certificates of the initial holder as the date of issue. The initial holder is the original purchaser who is issued stock of the Federal National Mortgage Association pursuant to section 303(c) of the Act, and who appears on the books of FNMA as the initial holder. In determining the period for which the initial holder has held such stock, such period shall begin with the date of issuance.

(b) *Examples.* The provisions of paragraph (a) of this section may be illustrated by the following examples:

Example (1). A, a banking institution which reports its income on a calendar year basis, sold mortgage paper with an outstanding principal balance of $12,500 to FNMA on October 17, 1960. The FNMA purchase price was $11,500. A's basis for the mortgage paper was $10,500. In accordance with the terms of the contract, FNMA deducted $375 ($250 representing capital contribution and $125 representing purchase and marketing fee) from the amount of the purchase price. FNMA credited A's account with the amount of the capital contribution. A stock certificate evidencing two shares of FNMA common stock of $100 par value was

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mailed to A and FNMA deducted $200 from A's account, leaving a net balance of $50 in such account. The stock certificate, bearing an issue date of November 1, 1960, was received by A on November 7, 1960. The fair market value of a share of FNMA stock on October 17, 1960, was $65, on November 1, 1960, was $67, and on November 7, 1960, was $68. A may deduct $66 the difference between the issuance price ($200) and the fair market value ($134) of the two shares of stock on the date of issuance (November 1, 1960), as a business expense for the taxable year 1960. The basis of each share of stock issued as of November 1, 1960 will be $67. See section 1054 and § 1.1054-1. A's gain from the sale of the mortgage paper is $875 computed as follows:

Amount realized in FNMA purchase price		$11,500
A's basis in mortgage paper	$10,500	
Purchase and marketing fee	125	
		10,625
Gain on sale		875

Example (2). Assume the same facts as in Example (1), and, in addition, that A sold to FNMA on December 15, 1960, additional mortgage paper having an outstanding principal balance of $12,500. FNMA deducted from the FNMA purchase price $250 representing capital contribution and credited A's account with this amount. A then had a total credit of $300 to his account consisting of the $50 balance from the transaction described in Example (1) and $250 from the December 15th transaction. A stock certificate evidencing three shares of FNMA common stock of $100 par value was mailed to A and FNMA deducted $300 from A's account. The stock certificate, bearing an issue date of January 1, 1961, was received by A on January 9, 1961. The fair market value of a share of FNMA stock on January 1, 1961, was $69. A may deduct $93, the difference between the issuance price ($300) and the fair market value ($207) of the three shares of stock on the date of issuance (January 1, 1961), as a business expense for the taxable year 1961. The gain or loss on the sale of mortgage paper on December 15, 1960, is reportable for the taxable year 1960.

[T.D. 6690, 28 FR 12253, Nov. 19, 1963]

§ 1.162-20 Expenditures attributable to lobbying, political campaigns, attempts to influence legislation, etc., and certain advertising.

(a) *In general*—(1) *Scope of section.* This section contains rules governing the deductibility or nondeductibility of expenditures for lobbying purposes, for the promotion or defeat of legislation, for political campaign purposes (including the support of or opposition to any candidate for public office) or for carrying on propaganda (including advertising) related to any of the foregoing purposes. For rules applicable to such expenditures in respect of taxable years beginning before January 1, 1963, and for taxable years beginning after December 31, 1962, see paragraphs (b) and (c), respectively, of this section. This section also deals with expenditures for institutional or "good will" advertising.

(2) *Institutional or "good will" advertising.* Expenditures for institutional or "good will" advertising which keeps the taxpayer's name before the public are generally deductible as ordinary and necessary business expenses provided the expenditures are related to the patronage the taxpayer might reasonably expect in the future. For example, a deduction will ordinarily be allowed for the cost of advertising which keeps the taxpayer's name before the public in connection with encouraging contributions to such organizations as the Red Cross, the purchase of United States Savings Bonds, or participation in similar causes. In like fashion, expenditures for advertising which presents views on economic, financial, social, or other subjects of a general nature, but which does not involve any of the activities specified in paragraph (b) or (c) of this section for which a deduction is not allowable, are deductible if they otherwise meet the requirements of the regulations under section 162.

(b) *Taxable years beginning before January 1, 1963*—(1) *In general.* (i) For taxable years beginning before January 1, 1963, expenditures for lobbying purposes, for the promotion or defeat of legislation, for political campaign purposes (including the support of or opposition to any candidate for public office), or for carrying on propaganda (including advertising) related to any of the foregoing purposes are not deductible from gross income. For example, the cost of advertising to promote or defeat legislation or to influence the public with respect to the desirability or undesirability of proposed legislation is not deductible as a business expense, even though the legisla-

tion may directly affect the taxpayer's business.

(ii) If a substantial part of the activities of an organization, such as a labor union or a trade association, consists of one or more of the activities specified in the first sentence of this subparagraph, deduction will be allowed only for such portion of the dues or other payments to the organization as the taxpayer can clearly establish is attributable to activities other than those so specified. The determination of whether such specified activities constitute a substantial part of an organization's activities shall be based on all the facts and circumstances. In no event shall special assessments or similar payments (including an increase in dues) made to any organization for any of such specified purposes be deductible. For other provisions relating to the deductibility of dues and other payments to an organization, such as a labor union or a trade association, see paragraph (c) of § 1.162-15.

(2) *Expenditures for promotion or defeat of legislation.* For purposes of this paragraph, expenditures for the promotion or the defeat of legislation include, but shall not be limited to, expenditures for the purpose of attempting to—

(i) Influence members of a legislative body directly, or indirectly by urging or encouraging the public to contact such members for the purpose of proposing, supporting, or opposing legislation, or

(ii) Influence the public to approve or reject a measure in a referendum, initiative, vote on a constitutional amendment, or similar procedure.

(c) *Taxable years beginning after December 31, 1962*—(1) *In general.* For taxable years beginning after December 31, 1962, certain types of expenses incurred with respect to legislative matters are deductible under section 162(a) if they otherwise meet the requirements of the regulations under section 162. These deductible expenses are described in subparagraph (2) of this paragraph. All other expenditures for lobbying purposes, for the promotion or defeat of legislation (see paragraph (b)(2) of this section), for political campaign purposes (including the support of or opposition to any candidate for public office), or for carrying on propaganda (including advertising) relating to any of the foregoing purposes are not deductible from gross income for such taxable years. For the disallowance of deductions for bad debts and worthless securities of a political party, see § 1.271-1. For the disallowance of deductions for certain indirect political contributions, such as the cost of certain advertising and the cost of admission to certain dinners, programs, and inaugural events, see § 1.276-1.

(2) *Appearances, etc., with respect to legislation*—(i) *General rule.* Pursuant to the provisions of section 162(e), expenses incurred with respect to legislative matters which may be deductible are those ordinary and necessary expenses (including, but not limited to, traveling expenses described in section 162(a)(2) and the cost of preparing testimony) paid or incurred by the taxpayer during a taxable year beginning after December 31, 1962, in carrying on any trade or business which are in direct connection with—

(*a*) Appearances before, submission of statements to, or sending communications to, the committees, or individual members of Congress or of any legislative body of a State, a possession of the United States, or a political subdivision of any of the foregoing with respect to legislation or proposed legislation of direct interest to the taxpayer, or

(*b*) Communication of information between the taxpayer and an organization of which he is a member with respect to legislation or proposed legislation of direct interest to the taxpayer and to such organization.

For provisions relating to dues paid or incurred with respect to an organization of which the taxpayer is a member, see subparagraph (3) of this paragraph.

(ii) *Legislation or proposed legislation of direct interest to the taxpayer*—(*a*) *Legislation or proposed legislation.* The term "legislation or proposed legislation" includes bills and resolutions introduced by a member of Congress or other legislative body referred to in subdivision (i)(*a*) of this subparagraph for consideration by such body as well

as oral or written proposals for legislative action submitted to the legislative body or to a committee or member of such body.

(b) *Direct interest—(1) In general.* (i) Legislation or proposed legislation is of direct interest to a taxpayer if the legislation or proposed legislation is of such a nature that it will, or may reasonably be expected to, affect the trade or business of the taxpayer. It is immaterial whether the effect, or expected effect, on the trade or business will be beneficial or detrimental to the trade or business or whether it will be immediate. If legislation or proposed legislation has such a relationship to a trade or business that the expenses of any appearance or communication in connection with the legislation meets the ordinary and necessary test of section 162(a), then such legislation ordinarily meets the direct interest test of section 162(e). However, if the nature of the legislation or proposed legislation is such that the likelihood of its having an effect on the trade or business of the taxpayer is remote or speculative, the legislation or proposed legislation is not of direct interest to the taxpayer. Legislation or proposed legislation which will not affect the trade or business of the taxpayer is not of direct interest to the taxpayer even though such legislation will affect the personal, living, or family activities or expenses of the taxpayer. Legislation or proposed legislation is not of direct interest to a taxpayer merely because it may affect business in general; however, if the legislation or proposed legislation will, or may reasonably be expected to, affect the taxpayer's trade or business it will be of direct interest to the taxpayer even though it also will affect the trade or business of other taxpayers or business in general. To meet the direct interest test, it is not necessary that all provisions of the legislation or proposed legislation have an effect, or expected effect, on the taxpayer's trade or business. The test will be met if one of the provisions of the legislation has the specified effect. Legislation or proposed legislation will be considered to be of direct interest to a membership organization if it is of direct interest to the organization, as such, or if it is of direct interest to one or more of its members.

(ii) Legislation which would increase or decrease the taxes applicable to the trade or business, increase or decrease the operating costs or earnings of the trade or business, or increase or decrease the administrative burdens connected with the trade or business meets the direct interest test. Legislation which would increase the social security benefits or liberalize the right to such benefits meets the direct interest test because such changes in the social security benefits may reasonably be expected to affect the retirement benefits which the employer will be asked to provide his employees or to increase his taxes. Legislation which would impose a retailer's sales tax is of direct interest to a retailer because, although the tax may be passed on to his customers, collection of the tax will impose additional burdens on the retailer, and because the increased cost of his products to the consumer may reduce the demand for them. Legislation which would provide an income tax credit or exclusion for shareholders is of direct interest to a corporation, because those tax benefits may increase the sources of capital available to the corporation. Legislation which would favorably or adversely affect the business of a competitor so as to affect the taxpayer's competitive position is of direct interest to the taxpayer. Legislation which would improve the school system of a community is of direct interest to a membership organization comprised of employers in the community because the improved school system is likely to make the community more attractive to prospective employees of such employers. On the other hand, proposed legislation relating to Presidential succession in the event of the death of the President has only a remote and speculative effect on any trade or business and therefore does not meet the direct interest test. Similarly, if a corporation is represented before a congressional committee to oppose an appropriation bill merely because of a desire to bring increased Government economy with the hope that such economy will eventually cause a reduction in the Federal income tax, the

legislation does not meet the direct interest test because any effect it may have upon the corporation's trade or business is highly speculative.

(2) *Appearances, etc., by expert witnesses.* (i) An appearance or communication (of a type described in paragraph (c)(2)(i)(*a*) of this section) by an individual in connection with legislation or proposed legislation shall be considered to be with respect to legislation of direct interest to such individual if the legislation is in a field in which he specializes as an employee, if the appearance or communication is not on behalf of his employer, and if it is customary for individuals in his type of employment to publicly express their views in respect of matters in their field of competence. Expenses incurred by such an individual in connection with such an appearance of communication, including traveling expenses properly allocable thereto, represent ordinary and necessary business expenses and are, therefore, deductible under section 162. For example, if a university professor who teaches in the field of money and banking appears, on his own behalf, before a legislative committee to testify on proposed legislation regarding the banking system, his expenses incurred in connection with such appearance are deductible under section 162 since university professors customarily take an active part in the development of the law in their field of competence and publicly communicate the results of their work.

(*ii*) An appearance or communication (of a type described in paragraph (c)(2)(i)(*a*) of this section) by an employee or self-employed individual in connection with legislation or proposed legislation shall be considered to be with respect to legislation of direct interest to such person if the legislation is in the field in which he specializes in his business (or as an employee) and if the appearance or communication is made pursuant to an invitation extended to him individually for the purpose of receiving his expert testimony. Expenses incurred by an employee or self-employed individual in connection with such an appearance or communication, including traveling expenses properly allocable thereto, represent ordinary and necessary business expenses and are, therefore, deductible under section 162. For example, if a self-employed individual is personally invited by a congressional committee to testify on proposed legislation in the field in which he specializes in his business, his expenses incurred in connection with such appearance are deductible under section 162. If a self-employed individual makes an appearance, on his own behalf, before a legislative committee without having been extended an invitation his expenses will be deductible to the extent otherwise provided in this paragraph.

(3) *Nominations, etc.* A taxpayer does not have a direct interest in matters such as nominations, appointments, or the operation of the legislative body.

(iii) *Allowable expenses.* To be deductible under section 162(a), expenditures which meet the tests of deductibility under the provisions of this paragraph must also qualify as ordinary and necessary business expenses under section 162(a) and, in addition, be in direct connection with the carrying on of the activities specified in subdivision (i)(*a*) or (i)(*b*) of this subparagraph. For example, a taxpayer appearing before a committee of the Congress to present testimony concerning legislation or proposed legislation in which he has a direct interest may deduct the ordinary and necessary expenses directly connected with his appearance, such as traveling expenses described in section 162(a)(2), and the cost of preparing testimony.

(3) *Deductibility of dues and other payments to an organization.* If a substantial part of the activities of an organization, such as a labor union or a trade association, consists of one or more of the activities to which this paragraph relates (legislative matters, political campaigns, etc.), exclusive of any activity constituting an appearance or communication with respect to legislation or proposed legislation of direct interest to the organization (see subparagraph (2)(ii)(*b*)(*1*)), a deduction will be allowed only for such portion of the dues or other payments to the organization as the taxpayer can clearly establish is attributable to ac-

tivities to which this paragraph does not relate and to any activity constituting an appearance or communication with respect to legislation or proposed legislation of direct interest to the organization. The determination of whether a substantial part of an organization's activities consists of one or more of the activities to which this paragraph relates (exclusive of appearances or communications with respect to legislation or proposed legislation of direct interest to the organization) shall be based on all the facts and circumstances. In no event shall a deduction be allowed for that portion of a special assessment or similar payment (including an increase in dues) made to any organization for any activity to which this paragraph relates if the activity does not constitute an appearance or communication with respect to legislation or proposed legislation of direct interest to the organization. If an organization pays or incurs expenses allocable to legislative activities which meet the tests of subdivisions (i) and (ii) of subparagraph (2) of this paragraph (appearances or communications with respect to legislation or proposed legislation of direct interest to the organization), on behalf of its members, the dues paid by a taxpayer are deductible to the extent used for such activities. Dues paid by a taxpayer will be considered to be used for such an activity, and thus deductible, although the legislation or proposed legislation involved is not of direct interest to the taxpayer, if, pursuant to the provisions of subparagraph (2)(ii)(*b*)(*1*) of this paragraph, the legislation or proposed legislation is of direct interest to the organization, as such, or is of direct interest to one or more members of the organization. For other provisions relating to the deductibility of dues and other payments to an organization, such as a labor union or a trade association, see paragraph (c) of § 1.162-15.

(4) *Limitations.* No deduction shall be allowed under section 162(a) for any amount paid or incurred (whether by way of contribution, gift, or otherwise) in connection with any attempt to influence the general public, or segments thereof, with respect to legislative matters, elections, or referendums. For example, no deduction shall be allowed for any expenses incurred in connection with "grassroot" campaigns or any other attempts to urge or encourage the public to contact members of a legislative body for the purpose of proposing, supporting, or opposing legislation.

[T.D. 6819, 30 FR 5581, Apr. 20, 1965, as amended by T.D. 6996, 34 FR 835, Jan. 18, 1969]

§ 1.162-21 Fines and penalties.

(a) *In general.* No deduction shall be allowed under section 162(a) for any fine or similar penalty paid to—

(1) The government of the United States, a State, a territory or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico;

(2) The government of a foreign country; or

(3) A political subdivision of, or corporation or other entity serving as an agency or instrumentality of, any of the above.

(b) *Definition.* (1) For purposes of this section a fine or similar penalty includes an amount—

(i) Paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding;

(ii) Paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Internal Revenue Code of 1954;

(iii) Paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or

(iv) Forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty.

(2) The amount of a fine or penalty does not include legal fees and related expenses paid or incurred in the defense of a prosecution or civil action arising from a violation of the law imposing the fine or civil penalty, nor court costs assessed against the taxpayer, or stenographic and printing charges. Compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as

amended) paid to a government do not constitute a fine or penalty.

(c) *Examples.* The application of this section may be illustrated by the following examples:

Example (1). M Corp. was indicted under section 1 of the Sherman Anti-Trust Act (15 U.S.C. 1) for fixing and maintaining prices of certain electrical products. M Corp. was convicted and was fined $50,000. The United States sued M Corp. under section 4A of the Clayton Act (15 U.S.C. 15a) for $100,000, the amount of the actual damages resulting from the price fixing of which M Corp. was convicted. Pursuant to a final judgment entered in the civil action, M Corp. paid the United States $100,000 in damages. Section 162(f) precludes M Corp. from deducting the fine of $50,000 as a trade or business expense. Section 162(f) does not preclude it from deducting the $100,000 paid to the United States as actual damages.

Example (2). N Corp. was found to have violated 33 U.S.C. 1321(b)(3) when a vessel it operated discharged oil in harmful quantities into the navigable waters of the United States. A civil penalty under 33 U.S.C. 1321(b)(6) of $5,000 was assessed against N Corp. with respect to the discharge. N Corp. paid $5,000 to the Coast Guard in payment of the civil penalty. Section 162(f) precludes N Corp. from deducting the $5,000 penalty.

Example (3). O Corp., a manufacturer of motor vehicles, was found to have violated 42 U.S.C. 1857f-2(a)(1) by selling a new motor vehicle which was not covered by the required certificate of conformity. Pursuant to 42 U.S.C. 1857f-4, O Corp. was required to pay, and did pay, a civil penalty of $10,000. In addition, pursuant to 42 U.S.C. 1857f-5a(c)(1), O Corp. was required to expend, and did expend, $500 in order to remedy the nonconformity of that motor vehicle. Section 162(f) precludes O Corp. from deducting the $10,000 penalty as a trade or business expense, but does not preclude it from deducting the $500 which it expended to remedy the nonconformity.

Example (4). P Corp. was the operator of a coal mine in which occurred a violation of a mandatory safety standard prescribed by the Federal Coal Mine Health and Safety Act of 1969 (30 U.S.C. 801 et seq.). Pursuant to 30 U.S.C. 819(a), a civil penalty of $10,000 was assessed against P Corp., and P Corp. paid the penalty. Section 162(f) precludes P Corp. from deducting the $10,000 penalty.

Example (5). Q Corp., a common carrier engaged in interstate commerce by railroad, hauled a railroad car which was not equipped with efficient hand brakes, in violation of 45 U.S.C. 11. Q Corp. was found to be liable for a penalty of $250 pursuant to 45 U.S.C. 13. Q Corp. paid that penalty. Section 162(f) precludes Q Corp. from deducting the $250 penalty.

Example (6). R Corp. owned and operated on the highways of State X a truck weighing in excess of the amount permitted under the law of State X. R Corp. was found to have violated the law and was assessed a fine of $85 which it paid to State X. Section 162(f) precludes R Corp. from deducting the amount so paid.

Example (7). S Corp. was found to have violated a law of State Y which prohibited the emission into the air of particulate matter in excess of a limit set forth in a regulation promulgated under that law. The Environmental Quality Hearing Board of State Y assessed a fine of $500 against S Corp. The fine was payable to State Y, and S Corp. paid it. Section 162(f) precludes S Corp. from deducting the $500 fine.

Example (8). T Corp. was found by a magistrate of City Z to be operating in such city an apartment building which did not conform to a provision of the city housing code requiring operable fire escapes on apartment buildings of that type. Upon the basis of the magistrate's finding, T Corp. was required to pay, and did pay, a fine of $200 to City Z. Section 162(f) precludes T Corp. from deducting the $200 fine.

[T.D. 7345, 40 FR 7437, Feb. 20, 1975; 40 FR 8948, Mar. 4, 1975, as amended by T.D. 7366, 40 FR 29290, July 11, 1975]

§ 1.162-22 Treble damage payments under the antitrust laws.

(a) *In general.* In the case of a taxpayer who after December 31, 1969, either is convicted in a criminal action of a violation of the Federal antitrust laws or enters a plea of guilty or *nolo contendere* to an indictment or information charging such a violation, and whose conviction or plea does not occur in a new trial following an appeal of a conviction on or before such date, no deduction shall be allowed under section 162(a) for two-thirds of any amount paid or incurred after December 31, 1969, with respect to—

(1) Any judgment for damages entered against the taxpayer under section 4 of the Clayton Act (15 U.S.C. 15), as amended, on account of such violation or any related violation of the Federal antitrust laws, provided such related violation occurred prior to the date of the final judgment of such conviction, or

(2) Settlement of any action brought under such section 4 on account of such violation or related violation.

For the purposes of this section, where a civil judgment has been entered or a settlement made with respect to a violation of the antitrust laws and a criminal proceeding is based upon the same violation, the criminal proceeding need not have been brought prior to the civil judgment or settlement. If, in his return for any taxable year, a taxpayer claims a deduction for an amount paid or incurred with respect to a judgment or settlement described in the first sentence of this paragraph and is subsequently convicted of a violation of the antitrust laws which makes a portion of such amount unallowable, then the taxpayer shall file an amended return for such taxable year on which the amount of the deduction is appropriately reduced. Attorney's fees, court costs, and other amounts paid or incurred in connection with a controversy under such section 4 which meet the requirements of section 162 are deductible under that section. For purposes of subparagraph (2) of this paragraph, the amount paid or incurred in settlement shall not include amounts attributable to the plaintiff's costs of suit and attorney's fees, to the extent that such costs or fees have actually been paid.

(b) *Conviction.* For purposes of paragraph (a) of this section, a taxpayer is convicted of a violation of the antitrust laws if a judgment of conviction (whether or not a final judgment) with respect to such violation has been entered against him, provided a subsequent final judgment of acquittal has not been entered or criminal prosecution with respect to such violation terminated without a final judgment of conviction. During the pendency of an appeal or other action directly contesting a judgment of conviction, the taxpayer should file a protective claim for credit or refund to avoid being barred by the period of limitations on credit or refund under section 6511.

(c) *Related violation.* For purposes of this section, a violation of the Federal antitrust laws is related to a subsequent violation if (1) with respect to the subsequent violation the United States obtains both a judgment in a criminal proceeding and an injunction against the taxpayer, and (2) the taxpayer's actions which constituted the prior violation would have contravened such injunction if such injunction were applicable at the time of the prior violation.

(d) *Settlement following a dismissal of an action or amendment of the complaint.* For purposes of paragraph (a)(2) of this section, an amount may be considered as paid in settlement of an action even though the action is dismissed or otherwise disposed of prior to such settlement or the complaint is amended to eliminate the claim with respect to the violation or related violation.

(e) *Antitrust laws.* The term "antitrust laws" as used in section 162(g) and this section shall include the Federal acts enumerated in paragraph (1) of section 1 of the Clayton Act (15 U.S.C. 12), as amended.

(f) *Examples.* The application of this section may be illustrated by the following examples:

Example (1). In 1970, the United States instituted a criminal prosecution against X Co., Y Co., A, the president of X Co., and B, the president of Y Co., under section 1 of the Sherman Anti-Trust Act, 15 U.S.C. 1. In the indictment, the defendants were charged with conspiring to fix and maintain prices of electrical transformers from 1965 to 1970. All defendants entered pleas of nolo contendere to these charges. These pleas were accepted and judgments of conviction entered. In a companion civil suit, the United States obtained an injunction prohibiting the defendants from conspiring to fix and maintain prices in the electrical transformer market. Thereafter, Z Co. sued X Co. and Y Co. for $300,000 in treble damages under section 4 of the Clayton Act. Z Co.'s complaint alleged that the criminal conspiracy between X Co. and Y Co. forced Z Co. to pay excessive prices for electrical transformers. X Co. and Y Co. each paid Z Co. $85,000 in full settlement of Z Co.'s action. Of each $85,000 paid, $10,000 was attributable to court costs and attorney's fees actually paid by Z Co. Under section 162(g), X Co. and Y Co. are each precluded from deducting as a trade or business expense more than $35,000 of the $85,000 paid to Z Co. in settlement—

$$\$10,000 + [(\$85,000 - \$10,000) \div 3]$$

Example (2). Assume the same facts as in example (1) except that Z Co.'s claim for treble damages was based on a conspiracy to fix and maintain prices in the sale of electrical transformers during 1963. Although the

criminal prosecution of the defendants did not involve 1963 (a year barred by the applicable criminal statute of limitations when the prosecution was instituted). Z Co.'s pleadings alleged that the civil statute of limitations had been tolled by the defendants' fraudulent concealment of their conspiracy. Since the United States has obtained both a judgment in a criminal proceeding and an injunction against the defendants in connection with their activities from 1965 to 1970, and the alleged actions of the defendants in 1963 would have contravened such injunction if it were applicable in 1963, the alleged violation in 1963 is related to the violation from 1965 to 1970. Accordingly, the tax consequences to X Co. and Y Co. of the payments of $85,000 in settlement of Z Co.'s claim against X Co. and Y Co. are the same as in example (1).

Example (3). Assume the same facts as in example (1) except that Z Co.'s claim for treble damages was based on a conspiracy to fix and maintain prices with respect to electrical insulators for high-tension power poles. Since the civil action was not based on the same violation of the Federal antitrust laws as the criminal action, or on a related violation (a violation which would have contravened the injunction if it were applicable), X Co. and Y Co. are not precluded by section 162(g) from deducting as a trade or business expense the entire $85,000 paid by each in settlement of the civil action.

[T.D. 7217, 37 FR 23916, Nov. 10, 1972]

§ 1.163-1 Interest deduction in general.

(a) Except as otherwise provided in sections 264 to 267, inclusive, interest paid or accrued within the taxable year on indebtedness shall be allowed as a deduction in computing taxable income. For rules relating to interest on certain deferred payments, see section 483 and the regulations thereunder.

(b) Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. Pursuant to the provisions of section 163(c), any annual or periodic rental payment made by a taxpayer on or after January 1, 1962, under a redeemable ground rent, as defined in section 1055(c) and paragraph (b) of § 1.1055-1, is required to be treated as interest on an indebtedness secured by a mortgage and, accordingly, may be deducted by the taxpayer as interest on his indebtedness. Section 163(c) has no application in respect of any annual or periodic rental payment made prior to January 1, 1962, or pursuant to an arrangement which does not constitute a "redeemable ground rent" as defined in section 1055(c) and paragraph (b) of § 1.1055-1. Accordingly, annual or periodic payments of Pennsylvania ground rents made before, on, or after January 1, 1962, are deductible as interest if the ground rent is redeemable. An annual or periodic rental payment under a Maryland redeemable ground rent made prior to January 1, 1962, is deductible in accordance with the rules and regulations applicable at the time such payment was made. Any annual or periodic rental payment under a Maryland redeemable ground rent made by the taxpayer on or after January 1, 1962, is, pursuant to the provisions of section 163(c), treated as interest on an indebtedness secured by a mortgage and, accordingly, is deductible by the taxpayer as interest on his indebtedness. In any case where the ground rent is irredeemable, any annual or periodic ground rent payment shall be treated as rent and shall be deductible only to the extent that the payment constitutes a proper business expense. Amounts paid in redemption of a ground rent shall not be treated as interest. For treatment of redeemable ground rents and real property held subject to liabilities under redeemable ground rents, see section 1055 and the regulations thereunder.

(c) Interest calculated for costkeeping or other purposes on account of capital or surplus invested in the business which does not represent a charge arising under an interest-bearing obligation, is not an allowable deduction from gross income. Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing taxable income. (See, however, section 583.) In the case of banks and loan or trust companies, interest paid within the year on deposits, such as interest paid on moneys received for investment and secured by interest-bearing

certificates of indebtedness issued by such bank or loan or trust company, may be deducted from gross income.

(d) To the extent of assistance payments made in respect of an indebtedness of the taxpayer during the taxable year by the Department of Housing and Urban Development under section 235 of the National Housing Act (12 U.S.C. 1715z), as amended, no deduction shall be allowed under section 163 and this section for interest paid or accrued with respect to such indebtedness. However, such payments shall not affect the amount of any deduction under any section of the Code other than section 163. The provisions of this paragraph shall apply to taxable years beginning after December 31, 1974.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6821, 30 FR 6216, May 4, 1965; T.D. 6873, 31 FR 941, Jan. 25, 1966; T.D. 7408, 41 FR 9547, Mar. 5, 1976]

§ 1.163-2 Installment purchases where interest charge is not separately stated.

(a) *In general.* (1) Whenever there is a contract with a seller for the purchase of personal property providing for payment of part or all of the purchase price in installments and there is a separately stated carrying charge (including a finance charge, service charge, and the like) but the actual interest charge cannot be ascertained, a portion of the payments made during the taxable year under the contract shall be treated as interest and is deductible under section 163 and this section. Section 163(b) contains a formula, described in paragraph (b) of this section, in accordance with which the amount of interest deductible in the taxable year must be computed. This formula is designed to operate automatically in the case of any installment purchase, without regard to whether payments under the contract are made when due or are in default. For applicable limitations when an obligation to pay is terminated, see paragraph (c) of this section.

(2) Whenever there is a contract with an educational institution for the purchase of educational services providing for payment of part or all of the purchase price in installments and there is a separately stated carrying charge (including a finance charge, service charge, and the like) but the actual interest charge cannot be ascertained, a portion of the payments made during the taxable year under the contract shall be treated as interest and is deductible under section 163 and this section. See paragraphs (b) and (c) of this section for the applicable computation and limitations rules. For purposes of section 163(b) and this section, the term "educational services" means any service (including lodging) which is purchased from an educational institution (as defined in section 151(e)(4) and paragraph (c) of § 1.151-3) and which is provided for a student of such institution.

(3) Section 163(b) and this section do not apply to a contract for the loan of money, even if the loan is to be repaid in installments and even if the borrowed amount is used to purchase personal property or educational services. In cases to which the preceding sentence applies, the portion of the installment payment which constitutes interest (as distinguished from payments of principal and charges such as payments for credit life insurance) is deductible under section 163(a) and § 1.163-1.

(b) *Computation.* The portion of any such payments to be treated as interest shall be equal to 6 percent of the average unpaid balance under the contract during the taxable year. For purposes of this computation, the average unpaid balance under the contract is the sum of the unpaid balance outstanding on the first day of each month beginning during the taxable year, divided by 12.

(c) *Limitations.* The amount treated as interest under section 163(b) and this section for any taxable year shall not exceed the amount of the payments made under the contract during the taxable year nor the aggregate carrying charges properly attributable to each contract for such taxable year. In computing the amount to be treated as interest if the obligation to pay is terminated as, for example, in the case of a repossession of the property, the unpaid balance on the first day of the month during which the obligation is terminated shall be zero.

(d) *Illustrations.* The provisions of this section may be illustrated by the following examples:

Example (1). On January 20, 1955, A purchased a television set for $400, including a stated carrying charge of $25. The down payment was $50, and the balance was paid in 14 monthly installments of $25 each, on the 20th day of each month commencing with February. Assuming that A is a cash method, calendar year taxpayer and that no other installment purchases were made, the amount to be treated as interest in 1955 is $12.38, computed as follows:

YEAR 1955

First day of	Unpaid balance outstanding
January	0
February	$350
March	325
April	300
May	275
June	250
July	225
August	200
September	175
October	150
November	125
December	100
	2,475

Sum of unpaid balances $2,475 ÷ 12 = $206.25; 6 percent thereof = $12.38.

Example (2). On November 20, 1955, B purchased a furniture set for $1,250, including a stated carrying charge of $48. The down payment was $50 and the balance was payable in 12 monthly installments of $100 each, on the first day of each month commencing with December 1955. Assume that B is a cash method, calendar year taxpayer and that no other installment purchases were made. Assume further that B made the first payment when due, but made only one other payment on June 1, 1956. The amount to be treated as interest in 1955 is $4, and the amount to be treated as interest in 1956 is $33, computed as follows:

YEAR 1955

First day of	Unpaid balance outstanding
December	$1,200

Sum of unpaid balances $1,200 ÷ 12 = $100; 6 percent thereof = $6.

Carrying charges attributable to 1955 = $4.

YEAR 1956

First day of	Unpaid balance outstanding
January	$1,100
February	1,000
March	900
April	800
May	700
June	600
July	500
August	400
September	300
October	200
November	100
	6,600

Sum of unpaid balances $6,600 ÷ 12 = $550; 6 percent thereof = $33.

Carrying charges attributable to 1956 = $44 ($4 × 11).

Example (3). Assume the same facts as in example (2), except that the furniture was repossessed and B's obligation to pay terminated as of July 15, 1956. The amount to be treated as interest in 1955 is $4, computed as in example (2) above. The amount to be treated as interest in 1956 is $25.50, computed as follows:

YEAR 1956

First day of	Unpaid balance outstanding
January	$1,100
February	1,000
March	900
April	800
May	700
June	600
July–November	0
	5,100

Sum of unpaid balances $5,100 ÷ 12 = $425. 6 percent thereof = $25.50.

Carrying charges attributable to 1956 = $44 ($4 × 11).

Example (4). (i) On September 15, 1968, C registered at X University for the 1968–69 academic year. C entered into an agreement with the X University for the purchase during such academic year of educational services (including lodging and tuition) for a total fee of $1,000, including a separately stated carrying charge of $50. Under the terms of the agreement, an initial payment of $200 was to be made by C on September 15, 1968, and the balance was to be paid in 8 monthly installments of $100 each, on the 15th day of each month commencing with

October 1968. C made all of the required 1968 payments. Assuming that C is a cash method, calendar year taxpayer and that no other installment purchases of services or property were made, the amount to be treated as interest in 1968 is $10.50, computed as follows:

YEAR 1968

First day of	Unpaid balance outstanding
January-September	0
October	$800
November	700
December	600
	2,100

The sum of unpaid balances ($2,100) divided by 12 is $175; 6 percent thereof is $10.50. The carrying charges attributable to 1968 are $18.75 (i.e., the total carrying charges ($50), divided by the total number of payments (8), multiplied by the number of payments made in 1968 (3)). Since the amount to be treated as interest in 1968 ($10.50) does not exceed the carrying charges attributable to 1968 ($18.75), the limitation set forth in paragraph (c) of this section is not applicable.

(ii) The result in this example would be the same even if the X University assigned the agreement to a bank or other financial institution and C made his payments directly to the bank or other financial institution.

Example (5). On September 15, 1968, D registered at Y University for the 1968-69 academic year. The tuition for such year was $1,500. In order to pay his tuition, D borrowed $1,500 from the M Corporation, a lending institution, and remitted that sum to the Y University. The loan agreement between M Corporation and D provided that D was to repay the loan, plus a service charge, in 10 equal monthly installments, on the first day of each month commencing with October 1968. The service charge consisted of interest and the cost of credit life insurance on D's life. Since section 163(b) and this section do not apply to a contract for the loan of money, D is not entitled to compute his interest deduction with respect to his loan from M Corporation under such sections. D may deduct that portion of each installment payment which constitutes interest (as distinguished from payments of principal and the charge for credit life insurance) under section 163(a) and § 1.163-1, provided that the amount of such interest can be ascertained.

(e) *Effective date.* Except in the case of payments made under a contract for educational services, the rule provided in section 163(b) and this section applies to payments made during taxable years beginning after December 31, 1953, and ending after August 16, 1954, regardless of when the contract of sale was made. In the case of payments made under a contract for educational services, the rule provided in section 163(b) and this section applies to payments made during taxable years beginning after December 31, 1963, regardless of when the contract for educational services was made.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6991, 34 FR 742, Jan. 17, 1969]

§ 1.163-3 Deduction for discount on bond issued on or before May 27, 1969.

(a) *Discount upon issuance.* (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity (or, in the case of a callable bond, at the earlier call date) over the issue price of the bond (as defined in paragraph (b)(2) of § 1.1232-3).

(2) In the case of a bond issued by a corporation after December 31, 1954, as part of an investment unit consisting of an obligation and an option, the issue price of the bond is determined by allocating the amount received for the investment unit to the individual elements of the unit in the manner set forth in subdivision (ii)(*a*) of § 1.1232-3(b)(2). Discount with respect to bonds issued by a corporation as part of investment units consisting of obligations and options after December 31, 1954, and before Dec. 24, 1968—

(i) Increased by any amount treated as bond premium which has been included in gross income with respect to such bonds prior to Dec. 24, 1968, or

(ii) Decreased by any amount which has been deducted by the issuer as discount attributable to such bonds prior to Dec. 24, 1968, and

(iii) Decreased by any amount which has been deducted by the issuer prior to Dec. 24, 1968 upon the exercise or sale by investors of options issued in investment units with such bonds,

should be amortized, starting with the first taxable year ending on or after Dec. 24, 1968 over the remaining life of such bonds.

(b) *Examples.* The rules in paragraph (a) of this section are illustrated by the following examples:

Example (1). M Corporation, on January 1, 1960, the beginning of its taxable year issued for $95,000, 3 percent bonds, maturing 10 years from the date of issue, with a stated redemption price at maturity of $100,000. M Corporation should treat $5,000 ($100,000-$95,000) as the total amount to be amortized over the life of the bonds.

Example (2). Assume the same facts as example (1), except that the bonds are convertible into common stock of M Corporation. Since the issue price of the bonds includes any amount attributable to the conversion privilege, the result is the same as in example (1).

Example (3). Assume the same facts as example (1), except that the bonds are issued as part of an investment unit consisting of an obligation and an option. Assume further that the issue price of the bonds as determined under the rules of allocation set forth in subdivision (ii) (*a*) of § 1.1232-3(b)(2) is $94,000. Accordingly, M Corporation should treat $6,000 ($100,000-$94,000) as the total amount to be amortized over the life of the bonds.

Example (4). Assume in example (3), that prior to Dec. 24, 1968, M Corporation had only treated $5,000 as the bond discount to be amortized and deducted only $4,000 of this amount. Starting with the first taxable year ending on or after Dec. 24, 1968, M Corporation should amortize $2,000 ($6,000 discount, less $4,000 previously deducted) over the remaining life of the bonds.

Example (5). N Corporation, on January 1, 1956, for a consideration of $102,000, issued 20-year bonds in the face amount of $100,000, together with options to purchase stock of N Corporation. The issue price of the bonds as determined under the rules of allocation set forth in subdivision (ii) (*a*) of § 1.1232-3(b)(2) is $99,000. Until Dec. 24, 1968, N Corporation has treated as bond premium, $2,000, representing the excess of the consideration received for the bond-option investment units over the maturity value of the bonds, and has accordingly prorated and included in income $1,200 of such amount. Starting with the first taxable year beginning on or after Dec. 24, 1968, N Corporation may amortize as a deduction over the remaining life of the bonds the amount of $2,200 ($1,000 discount, plus $1,200 previously included in income).

Example (6). O Corporation, on January 1, 1956, for a consideration of $100,000, issued 20-year bonds with a $100,000 face value, together with options to purchase stock of O Corporation, which could be exercised at any time up to 5 years from the date of issue. The issue price of the bonds as determined under the rules of allocation set forth in subdivision (ii)(*a*) of § 1.1232-3(b)(2) is $98,000. O Corporation, upon the exercise of the options prior to Dec. 24, 1968, had deducted from income their fair market value at the time of exercise, which is assumed for purposes of this example to have been $3,000. Even though the bonds are considered to have been issued at a discount under paragraph (a)(1) of this section, O Corporation would have no deduction over the remaining life of the bonds, inasmuch as O Corporation, in computing the amount of such deduction, is required under paragraph (a)(2)(iii) of this section to reduce the amount which would otherwise be treated as bond discount, $2,000 ($100,000-$98,000), by the amount deducted from income upon the exercise of the options, in this case, $3,000.

(c) *Deduction upon repurchase.* (1) Except as provided in subparagraphs (2) and (3) of this paragraph, if bonds are issue by a corporation and are subsequently repurchased by the corporation at a price in excess of the issue price plus any amount of discount deducted prior to repurchase, or (in the case of bonds issued subsequent to Feb. 28, 1913) minus any amount of premium returned as income prior to repurchase, the excess of the purchase price over the issue price adjusted for amortized premium or discount is a deductible expense for the taxable year.

(2) In the case of a convertible bond (except a bond which the corporation, before Sept. 5, 1968, has obligated itself to repurchase at a specified price), the deduction allowable under subparagraph (1) of this paragraph may not exceed an amount equal to 1 year's interest at the rate specified in the bond, except to the extent that the corporation can demonstrate to the satisfaction of the Commissioner or his delegate that an amount in excess of 1 year's interest does not include any amount attributable to the conversion feature.

(3) No deduction shall be allowed under subparagraph (1) of this paragraph to the extent a deduction is disallowed under subparagraph (2) of this paragraph or to the extent a deduction is disallowed by section 249 (relating to limitation on deduction of

bond premium on repurchase of convertible obligation) and the regulations thereunder. See paragraph (f) of § 1.249-1 for effective date limitation on section 249.

(d) *Definition.* For purposes of this section, a debenture, note, certificate other evidence of indebtedness, issued by a corporation and bearing interest shall be given the same treatment as a bond.

(e) *Effective date.* The provisions of this section shall not apply in respect of a bond issued after May 27, 1969, unless issued pursuant to a written commitment which was binding on that date and at all times thereafter.

[T.D. 6984, 33 FR 19175, Dec. 24, 1968; 36 FR 24996, Dec. 28, 1971, as amended by T.D. 7259, 38 FR 4253, Feb. 12, 1973]

§ 1.163-4 Deduction for original issue discount on certain obligations issued after May 27, 1969.

(a) *In general.* (1) If an obligation is issued by a corporation with original issue discount, the amount of such discount is deductible as interest and shall be prorated or amortized over the life of the obligation. For purposes of this section the term "obligation" shall have the same meaning as in § 1.1232-1 (without regard to whether the obligation is a capital asset in the hands of the holder) and the term "original issue discount" shall have the same meaning as in section 1232(b)(1) (without regard to the one-fourth of 1 percent limitation in the second sentence thereof). Thus, in general, the amount of original issue discount equals the excess of the amount payable at maturity over the issue price of the bond (as defined in paragraph (b)(2) of § 1.1232-3), regardless of whether that amount is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of complete years to maturity. For the rule as to whether there is original issue discount in the case of an obligation issued in an exchange for property other than money, and the amount thereof, see paragraph (b)(2)(iii) of § 1.1232-3. In any case in which original issue discount is carried over from one corporation to another corporation under section 381(c)(9) or from an obligation exchanged to an obligation received in any exchange under paragraph (b)(1)(iv) of § 1.1232-3, such discount shall be carried over for purposes of this section. The amount of original issue discount carried over in an exchange of obligations under the preceding sentence shall be prorated or amortized over the life of the obligation issued in such exchange. For computation of issue price and the amount of original issue discount in the case of serial obligations, see paragraph (b)(2)(iv) of § 1.1232-3.

(2) In the case of an obligation issued by a corporation as part of an investment unit (as defined in paragraph (b)(2)(ii)(*a*) of § 1.1232-3) consisting of an obligation and other property, the issue price of the obligation is determined by allocating the amount received for the investment unit to the individual elements of the unit in the manner set forth in paragraph (b)(2)(ii) of § 1.1232-3.

(3) *Recovery or retention of amounts previously deducted.* In any taxable year in which an amount of original issue discount which was deducted as interest under this section is retained or recovered by the taxpayer, such as, for example, by reason of a fine, penalty, forfeiture, or other withdrawal fee, such amount shall be includible in the gross income of such taxpayer for such taxable year.

(b) *Examples.* The rules in paragraph (a) of this section are illustrated by the following examples:

Example (1). N Corporation, which uses the calendar year as its taxable year, on January 1, 1970, issued for $99,000, 9 percent bonds maturing 10 years from the date of issue, with a stated redemption price at maturity of $100,000. The original issue discount on each bond (as determined under section 1232(b)(1) without regard to the one-fourth-of-1-percent limitation in the second sentence thereof) is $1,000, i.e., redemption price, $100,000, minus issue price, $99,000. N shall treat $1,000 as the total amount to be amortized over the life of the bonds.

Example (2). Assume the same facts as example (1), except that the bonds are convertible into common stock of N Corporation. Since the issue price of the bonds includes any amount attributable to the conversion privilege, the result is the same as in example (1).

Example (3). Assume the same facts as example (1), except that the bonds are issued as part of an investment unit consisting of an obligation and an option. Assume further that the issue price of the bonds as determined under the rules of allocation set forth in paragraph (b)(2)(ii) of § 1.1232-3 is $94,000. The original issue discount on the bond (as determined under section 1232(b)(1) without regard to the one-fourth-of-1-percent limitation in the second sentence thereof) is $6,000, i.e., redemption price, $100,000, minus issue price, $94,000. N shall treat $6,000 as the total amount to be amortized over the life of the bonds.

Example (4). On January 1, 1971, a commercial bank which uses the calendar year as its taxable year, issued a certificate of deposit for $10,000. The certificate of deposit is not redeemable until December 31, 1975, except in an emergency as defined in, and subject to the qualifications provided by, Regulations Q of the Board of Governors of the Federal Reserve. See 12 CFR § 217.4(d). The stated redemption price at maturity is $13,382.26. The certificate is an obligation to which section 1232(a)(3)(A) applies (see paragraph (d) of § 1.1232-1), and the original issue discount with respect to the certificate (as determined under section 1232(b)(1) without regard to the one-fourth-of-1-percent limitation in the second sentence thereof) is $3,382.26 (i.e., redemption price, $13,382.26, minus issued price, $10,000). Y shall treat $3,382.26 as the total amount to be amortized over the life of the certificate.

(c) *Deduction upon repurchase.* (1) Except as provided in subparagraph (2) of this paragraph, if bonds are issued by a corporation and are subsequently repurchased by the corporation at a price in excess of the issue price plus any amount of original issue discount deducted prior to repurchase, or minus any amount of premium returned as income prior to repurchase, the excess of the repurchase price over the issue price adjusted for amortized premium or deducted discount is deductible as interest for the taxable year.

(2) The provisions of subparagraph (1) of this paragraph shall not apply to the extent a deduction is disallowed by section 249 (relating to limitation on deduction of bond premium or repurchase of convertible obligation) and the regulations thereunder.

(d) *Effective date.* The provisions of this section shall apply in respect of obligations issued after May 27, 1969, other than—

(1) Obligations issued pursuant to a written commitment which was binding on May 27, 1969, and at all times thereafter, and

(2) Deposits made before January 1, 1971, in the case of certificates of deposit, time deposits, bonus plans, and other deposit arrangements with banks, domestic building and loan associations, and similar financial institutions.

[36 FR 24996, Dec. 28, 1971, as amended by T.D. 7213, 37 FR 21991, Oct. 18, 1972; T.D. 7259, 38 FR 4253, Feb. 12, 1973]

§ 1.164-1 Deduction for taxes.

(a) *In general.* Only the following taxes shall be allowed as a deduction under this section for the taxable year within which paid or accrued, according to the method of accounting used in computing taxable income:

(1) State and local, and foreign, real property taxes.

(2) State and local personal property taxes.

(3) State and local, and foreign, income, war profits, and excess profits taxes.

(4) State and local general sales taxes.

(5) State and local taxes on the sale of gasoline, diesel fuel, and other motor fuels.

In addition, there shall be allowed as a deduction under this section State and local and foreign taxes not described in subparagraphs (1) through (5) of this paragraph which are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for production of income). For example, dealers or investors in securities and dealers or investors in real estate may deduct State stock transfer and real estate transfer taxes, respectively, under section 164, to the extent they are expenses incurred in carrying on a trade or business or an activity for the production of income. In general, taxes are deductible only by the person upon whom they are imposed. However, see § 1.164-5 in the case of certain taxes paid by the consumer. Also, in the case of a qualified State individual income tax (as defined in section 6362 and the regulations there-

under) which is determined by reference to a percentage of the Federal income tax (pursuant to section 6362 (c)), an accrual method taxpayer shall use the cash receipts and disbursements method to compute the amount of his deduction therefor. Thus, the deduction under section 164 is in the amount actually paid with respect to the qualified tax, rather than the amount accrued with respect thereto, during the taxable year even though the taxpayer uses the accrual method of accounting for other purposes. In addition, see paragraph (f)(1) of § 301.6361-1 of this chapter (Regulations on Procedure and Administration) with respect to rules relating to allocation and reallocation of amounts collected on account of the Federal income tax and qualified taxes.

(b) *Taxable years beginning before January 1, 1964.* For taxable years beginning before January 1, 1964, except as otherwise provided in §§ 1.164-2 through 1.164-8, inclusive, taxes imposed by the United States, any State, territory, possession of the United States, or a political subdivision of any of the foregoing, or by any foreign country, are deductible from gross income for the taxable year in which paid or accrued, according to the method of accounting used in computing taxable income. For this purpose, postage is not a tax and automobile license or registration fees are ordinarily taxes.

(c) *Cross references.* For the definition of the term "real property taxes", see paragraph (d) of § 1.164-3. For the definition of the term "foreign taxes", see paragraph (d) of § 1.164-3. For the definition of the term "general sales taxes", see paragraph (f) of § 1.164-3. For the treatment of gasoline, diesel fuel, and other motor fuel taxes, see § 1.164-5. For apportionment of taxes on real property between seller and purchaser, see section 164(d) and § 1.164-6. For the general rule for taxable year of deduction, see section 461. For provisions disallowing any deduction for the tax paid at the source on interest from tax-free covenant bonds, see section 1451(f).

[T.D. 6780, 29 FR 18145, Dec. 22, 1964, as amended by T.D. 7577, 43 FR 59357, Dec. 20, 1978]

§ 1.164-2 Deduction denied in case of certain taxes.

This section and § 1.275 describe certain taxes for which no deduction is allowed. In the case of taxable years beginning before January 1, 1964, the denial is provided for by section 164(b) (prior to being amended by section 207 of the Revenue Act of 1964 (78 Stat. 40)). In the case of taxable years beginning after December 31, 1963, the denial is governed by sections 164 and 275. No deduction is allowed for the following taxes:

(a) *Federal income taxes.* Federal income taxes, including the taxes imposed by section 3101, relating to the tax on employees under the Federal Insurance Contributions Act (chapter 21 of the Code); sections 3201 and 3211, relating to the taxes on railroad employees and railroad employee representatives; section 3402, relating to the tax withheld at source on wages; and by corresponding provisions of prior internal revenue laws.

(b) *Federal war profits and excess profits taxes.* Federal war profits and excess profits taxes including those imposed by Title II of the Revenue Act of 1917 (39 Stat. 1000), Title III of the Revenue Act of 1918 (40 Stat. 1088), Title III of the Revenue Act of 1921 (42 Stat. 271), section 216 of the National Industrial Recovery Act (48 Stat. 208), section 702 of the Revenue Act of 1934 (48 Stat. 770), Subchapter D, Chapter 1 of the Internal Revenue Code of 1939, and subchapter E, chapter 2 of the Internal Revenue Code of 1939.

(c) *Estate and gift taxes.* Estate, inheritance, legacy, succession, and gift taxes.

(d) *Foreign income, war profits, and excess profits taxes.* Income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States, if the taxpayer chooses to take to any extent the benefits of section 901, relating to the credit for taxes of foreign countries and possessions of the United States.

(e) *Real property taxes.* Taxes on real property, to the extent that section 164(d) and § 1.164-6 require such

taxes to be treated as imposed on another taxpayer.

(f) *Federal duties and excise taxes.* Federal import or tariff duties, business, license, privilege, excise, and stamp taxes (not described in paragraphs (a), (b) (c), or (h) of this section, or § 1.164-4) paid or accrued within the taxable year. The fact that any such tax is not deductible as a tax under section 164 does not prevent (1) its deduction under section 162 or section 212, provided it represents an ordinary and necessary expense paid or incurred during the taxable year by a corporation or an individual in the conduct of any trade or business or, in the case of an individual for the production or collection of income, for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection, or refund of any tax, or (2) its being taken into account during the taxable year by a corporation or an individual as a part of the cost of acquiring or producing property in the trade or business or, in the case of an individual, as a part of the cost of property held for the production of income with respect to which it relates.

(g) *Taxes for local benefits.* Except as provided in § 1.164-4, taxes assessed against local benefits of a kind tending to increase the value of the property assessed.

(h) *Excise tax on real estate investment trusts.* The excise tax imposed on certain real estate investment trusts by section 4981.

[T.D. 6780, 29 FR 18145, Dec 22, 1964, as amended by T.D. 7767, 46 FR 11263, Feb. 6, 1981]

§ 1.164-3 Definitions and special rules.

For purposes of section 164 and § 1.164-1 to § 1.164-8, inclusive—

(a) *State or local taxes.* A State or local tax includes only a tax imposed by a State, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia.

(b) *Real property taxes.* The term "real property taxes" means taxes imposed on interests in real property and levied for the general public welfare, but it does not include taxes assessed against local benefits. See § 1.164-4.

(c) *Personal property taxes.* The term "personal property tax" means an ad valorem tax which is imposed on an annual basis in respect of personal property. To qualify as a personal property tax, a tax must meet the following three tests:

(1) The tax must be ad valorem—that is, substantially in proportion to the value of the personal property. A tax which is based on criteria other than value does not qualify as ad valorem. For example, a motor vehicle tax based on weight, model year, and horsepower, or any of these characteristics is not an ad valorem tax. However, a tax which is partly based on value and partly based on other criteria may qualify in part. For example, in the case of a motor vehicle tax of 1 percent of value plus 40 cents per hundredweight, the part of the tax equal to 1 percent of value qualifies as an ad valorem tax and the balance does not qualify.

(2) The tax must be imposed on an annual basis, even if collected more frequently or less frequently.

(3) The tax must be imposed in respect of personal property. A tax may be considered to be imposed in respect of personal property even if in form it is imposed on the exercise of a privilege. Thus, for taxable years beginning after December 31, 1963, State and local taxes on the registration or licensing of highway motor vehicles are not deductible as personal property taxes unless and to the extent that the tests prescribed in this subparagraph are met. For example, an annual ad valorem tax qualifies as a personal property tax although it is denominated a registration fee imposed for the privilege of registering motor vehicles or of using them on the highways.

(d) *Foreign taxes.* The term "foreign tax" includes only a tax imposed by the authority of a foreign country. A tax-imposed by a political subdivision of a foreign country is considered to be imposed by the authority of that foreign country.

(e) *Sales tax.* (1) The term "sales tax" means a tax imposed upon persons engaged in selling tangible per-

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sonal property, or upon the consumers of such property, including persons selling gasoline or other motor vehicle fuels at wholesale or retail, which is a stated sum per unit of property sold or which is measured by the gross sales price or the gross receipts from the sale. The term also includes a tax imposed upon persons engaged in furnishing services which is measured by the gross receipts for furnishing such services.

(2) In general, the term "consumer" means the ultimate user or purchaser; it does not include a purchaser such as a retailer, who acquires the property for resale.

(f) *General sales tax.* A "general sales tax" is a sales tax which is imposed at one rate in respect of the sale at retail of a broad range of classes of items. No foreign sales tax is deductible under section 164(a) and paragraph (a)(4) of § 1.164-1. To qualify as a general sales tax, a tax must meet the following two tests:

(1) The tax must be a tax in respect of sales at retail. This may include a tax imposed on persons engaged in selling property at retail or furnishing services at retail, for example, if the tax is measured by gross sales price or by gross receipts from sales or services. Rentals qualify as sales at retail if so treated under applicable State sales tax laws.

(2) The tax must be general—that is, it must be imposed at one rate in respect of the retail sales of a broad range of classes of items. A sales tax is considered to be general although imposed on sales of various classes of items at more than one rate provided that one rate applies to the retail sales of a broad range of classes of items. The term "items" includes both commodities and services.

(g) *Special rules relating to general sales taxes.* (1) A sales tax which is general is usually imposed at one rate in respect of the retail sales of all tangible personal property (with exceptions and additions). However, a sales tax which is selective—that is, a tax which applies at one rate with respect to retail sales of specified classes of items also qualifies as general if the specified classes represent a broad range of classes of items. A selective sales tax which does not apply at one rate to the retail sales of a broad range of classes of items is not general. For example, a tax which applies only to sales of alcoholic beverages, tobacco, admissions, luxury items, and a few other items is not general. Similarly, a tax imposed solely on services is not general. However, a selective sales tax may be deemed to be part of the general sales tax and hence may be deductible, even if imposed by a separate Title, etc., of the State or local law, if imposed at the same rate as the general rate of tax (as defined in subparagraph (4) of this paragraph) which qualifies a tax in the taxing jurisdiction as a general sales tax. For example, if a State has a 5 percent general sales tax and a separate selective sales tax of 5 percent on transient accommodations, the tax on transient accommodations is deductible.

(2) A tax is imposed at one rate only if it is imposed at that rate on generally the same base for all items subject to tax. For example, a sales tax imposed at a 3 percent rate on 100 percent of the sales price of some classes of items and at a 3 percent rate on 50 percent of the sales price of other classes of items would not be imposed at one rate with respect to all such classes. However, a tax is considered to be imposed at one rate although it allows dollar exemptions, if the exemptions are designed to exclude all sales under a certain dollar amount. For example, a tax may be imposed at one rate although it applies to all sales of tangible personal property but applies only to sales amounting to more than 10 cents.

(3) The fact that a sales tax exempts food, clothing, medical supplies, and motor vehicles, or any of them, shall not be taken into account in determining whether the tax applies to a broad range of classes of items. The fact that a sales tax applies to food, clothing, medical supplies, and motor vehicles, or any of them, at a rate which is lower than the general rate of tax (as defined in subparagraph (4) of this paragraph) is not taken into account in determining whether the tax is imposed at one rate on the retail sales of a broad range of classes of items. For purposes of this section, the term

"food" means food for human consumption off the premises where sold, and the term "medical supplies" includes drugs, medicines, and medical devices.

(4) Except in the case of a lower rate of tax applicable in respect of food, clothing, medical supplies, and motor vehicles, or any of them, no deduction is allowed for a general sales tax in respect of any item if the tax is imposed on such item at a rate other than the general rate of tax. The general rate of tax is the one rate which qualifies a tax in a taxing jurisdiction as a general sales tax because the tax is imposed at such one rate on a broad range of classes of items. There can be only one general rate of tax in any one taxing jurisdiction. However, a general sales tax imposed at a lower rate or rates on food, clothing, motor vehicles, and medical supplies, or any of them, may nonetheless be deductible with respect to such items. For example, a sales tax which is imposed at 1 percent with respect to food, imposed at 3 percent with respect to a broad range of classes of tangible personal property, and imposed at 4 percent with respect to transient accommodations would qualify as a general sales tax. Taxes paid at the 1 percent and the 3 percent rates are deductible, but tax paid at the 4 percent rate is not deductible. The fact that a sales tax provides for the adjustment of the general rate of tax to reflect the sales tax rate in another taxing jurisdiction shall not be taken into account in determining whether the tax is imposed at one rate on the retail sales of a broad range of classes of items. Moreover, a general sales tax imposed at a lower rate with respect to an item in order to reflect the tax rate in another jurisdiction is also deductible at such lower rate. For example, State E imposes a general sales tax whose general rate is 3 percent. The State E sales tax law provides that in areas bordering on States with general sales taxes, selective sales taxes, or special excise taxes, the rate applied in the adjoining State will be used if such rate is under 3 percent. State F imposes a 2 percent sales tax. The 2 percent sales tax paid by residents of State E in areas bordering on State F is deductible.

(h) *Compensating use taxes.* A compensating use tax in respect of any item is treated as a general sales tax. The term "compensating use tax" means, in respect of any item, a tax which is imposed on the use, storage, or consumption of such item and which is complementary to a general sales tax which is deductible with respect to sales of similar items.

(i) *Special rules relating to compensating use taxes.* (1) In general, a use tax on an item is complementary to a general sales tax on similar items if the use tax is imposed on an item which was not subject to such general sales tax but which would have been subject to such general sales tax if the sale of the item had taken place within the jurisdiction imposing the use tax. For example, a tax imposed by State A on the use of a motor vehicle purchased in State B is complementary to the general sales tax of State A on similar items, if the latter tax applies to motor vehicles sold in State A.

(2) Since a compensating use tax is treated as a general sales tax, it is subject to the rule of subparagraph (C) of section 164(b)(2) and paragraph (g)(4) of this section that no deduction is allowed for a general sales tax imposed in respect of an item at a rate other than the general rate of tax (except in the case of lower rates on the sale of food, clothing, medical supplies, and motor vehicles). The fact that a compensating use tax in respect of any item provides for an adjustment in the rate of the compensating use tax or the amount of such tax to be paid on account of a sales tax on such item imposed by another taxing jurisdiction is not taken into account in determining whether the compensating use tax is imposed in respect of the item at a rate other than the general rate of tax. For example, a compensating use tax imposed by State C on the use of an item purchased in State D is considered to be imposed at the general rate of tax even though the tax imposed by State C allows a credit for any sales tax paid on such item in State D, or the rate of such compensating use tax is adjusted to reflect the rate of sales tax imposed by State D.

[T.D. 6780, 29 FR 18146, Dec. 22, 1964]

§ 1.164-4 Taxes for local benefits.

(a) So-called taxes for local benefits referred to in paragraph (g) of § 1.164-2, more properly assessments, paid for local benefits such as street, sidewalk, and other like improvements, imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied are not deductible as taxes. A tax is considered assessed against local benefits when the property subject to the tax is limited to property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. The real property taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction. Assessments under the statutes of California relating to irrigation, and of Iowa relating to drainage, and under certain statutes of Tennessee relating to levees, are limited to property benefited, and if the assessments are so limited, the amounts paid thereunder are not deductible as taxes. For treatment of assessments for local benefits as adjustments to the basis of property, see section 1016(a)(1) and the regulations thereunder.

(b)(1) Insofar as assessments against local benefits are made for the purpose of maintenance or repair or for the purpose of meeting interest charges with respect to such benefits, they are deductible. In such cases, the burden is on the taxpayer to show the allocation of the amounts assessed to the different purposes. If the allocation cannot be made, none of the amount so paid is deductible.

(2) Taxes levied by a special taxing district which was in existence on December 31, 1963, for the purpose of retiring indebtedness existing on such date, are deductible, to the extent levied for such purpose, if (i) the district covers the whole of at least one county, (ii) if at least 1,000 persons are subject to the taxes levied by the district, and (iii) if the district levies its assessments annually at a uniform rate on the same assessed value of real property, including improvements, as is used for purposes of the real property tax generally.

[T.D. 6780, 29 FR 18147, Dec. 22, 1964]

§ 1.164-5 Certain retail sales taxes and gasoline taxes.

For taxable years beginning before January 1, 1964, any amount representing a State or local sales tax paid by a consumer of services or tangible personal property is deductible by such consumer as a tax, provided it is separately stated and not paid in connection with his trade or business. For taxable years beginning after December 31, 1963, only the amount of any separately stated State and local general sales tax (as defined in paragraph (g) of § 1.164-3) and tax on the sale of gasoline, diesel fuel or other motor fuel paid by the consumer (other than in connection with his trade or business) is deductible by the consumer as tax. The fact that, under the law imposing it, the incidence of such State or local tax does not fall on the consumer is immaterial. The requirement that the amount of tax must be separately stated will be deemed complied with where it clearly appears that at the time of sale to the consumer, the tax was added to the sales price and collected or charged as a separate item. It is not necessary, for the purpose of this section, that the consumer be furnished with a sales slip, bill, invoice, or other statement on which the tax is separately stated. For example, where the law imposing the State or local tax for which the taxpayer seeks a deduction contains a prohibition against the seller absorbing the tax, or a provision requiring a posted notice stating that the tax will be added to the quoted price, or a requirement that the tax be separately shown in advertisements or separately stated on all bills and invoices, it is presumed that the amount of the State or local tax was separately stated at the time paid by the consumer; except that such presumption shall have no application to a tax on the sale of gasoline, diesel fuel or other motor fuel imposed upon a wholesaler unless such provisions of law apply with respect to

both the sale at wholesale and the sale at retail.

[T.D. 6780, 29 FR 18147, Dec. 22, 1964]

§ 1.164-6 Apportionment of taxes on real property between seller and purchaser.

(a) *Scope.* Except as provided otherwise in section 164(f) and § 1.164-8, when real property is sold, section 164(d)(1) governs the deduction by the seller and the purchaser of current real property taxes. Section 164(d)(1) performs two functions: (1) It provides a method by which a portion of the taxes for the real property tax year in which the property is sold may be deducted by the seller and a portion by the purchaser; and (2) it limits the deduction of the seller and the purchaser to the portion of the taxes corresponding to the part of the real property tax year during which each was the owner of the property. These functions are accomplished by treating a portion of the taxes for the real property tax year in which the property is sold as imposed on the seller and a portion as imposed on the purchaser. To the extent that the taxes are treated as imposed on the seller and the purchaser, each shall be allowed a deduction, under section 164(a), in the taxable year such tax is paid or accrued, or treated as paid or accrued under section 164(d)(2) (A) or (D) and this section. No deduction is allowed for taxes on real property to the extent that they are imposed on another taxpayer, or are treated as imposed on another taxpayer under section 164(d). For the election to accrue real property taxes ratably see section 461(c) and the regulations thereunder.

(b) *Application of rule of apportionment.* (1)(i) For purposes of the deduction provided by section 164(a), if real property is sold during any real property tax year, the portion of the real property tax properly allocable to that part of the real property tax year which ends on the day before the date of the sale shall be treated as a tax imposed on the seller, and the portion of such tax properly allocable to that part of such real property tax year which begins on the date of the sale shall be treated as a tax imposed on the purchased. For definition of "real property tax year" see paragraph (c) of this section. This rule shall apply whether or not the seller and the purchaser apportion such tax. The rule of apportionment contained in section 164(d)(1) applies even though the same real property is sold more than once during the real property tax year. (See paragraph (d)(5) of this section for rule requiring inclusion in gross income of excess deductions.)

(ii) Where the real property tax becomes a personal liability or a lien before the beginning of the real property tax year to which it relates and the real property is sold subsequent to the time the tax becomes a personal liability or a lien but prior to the beginning of the related real property tax year—

(*a*) The seller may not deduct any amount for real property taxes for the related real property tax year, and

(*b*) To the extent that he holds the property for such real property tax year, the purchaser may deduct the amount of such taxes for the taxable year they are paid (or amounts representing such taxes are paid to the seller, mortgagee, trustee or other person having an interest in the property as security) or accrued by him according to his method of accounting.

(iii) Similarly, where the real property tax becomes a personal liability or a lien after the end of the real property tax year to which it relates and the real property is sold prior to the time the tax becomes a personal liability or a lien but after the end of the related real property tax year—

(*a*) The purchaser may not deduct any amount for real property taxes for the related real property tax year, and

(*b*) To the extent that he holds the property for such real property tax year, the seller may deduct the amount of such taxes for the taxable year they are paid (or amounts representing such taxes are paid to the purchaser, mortgagee, trustee, or other person having an interest in the property as security) or accrued by him according to his method of accounting.

(iv) Where the real property is sold (or purchased) during the related real property tax year the real property taxes for such year are apportioned between the parties to such sale and may be deducted by such parties in ac-

cordance with the provisions of paragraph (d) of this section.

(2) Section 164(d) does not apply to delinquent real property taxes for any real property tax year prior to the real property tax year in which the property is sold.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example (1). The real property tax year in County R is April 1 to March 31. A, the owner on April 1, 1954, of real property located in County R sells the real property to B on June 30, 1954. B owns the real property from June 30, 1954, through March 31, 1955. The real property tax for the real property tax year April 1, 1954-March 31, 1955 is $365. For purposes of section 164(a), $90 (90/365×$365, April 1, 1954-June 29, 1954) of the real property tax is treated as imposed on A, the seller, and $275 (275/365× $365, June 30, 1954-March 31, 1955) of such real property tax is treated as imposed on B, the purchaser.

Example (2). In County S the real property tax year is the calendar year. The real property tax becomes a lien on June 1 and is payable on July 1 of the current real property tax year, but there is no personal liability for such tax. On April 30, 1955, C, the owner of real property in County S on January 1, 1955, sells the real property to D. On July 1, 1955, D pays the 1955 real property tax. On August 31, 1955, D sells the same real property to E. C, D, and E use the cash receipts and disbursements method of accounting. Under the provisions of section 164(d)(1), 119/365 (January 1-April 29, 1955) of the real property tax payable on July 1, 1955, for the 1955 real property tax year is treated as imposed on C, and, under the provisions of section 164(d)(2)(A), such portion is treated as having been paid by him on the date of sale. Under the provisions of section 164(d)(1), 123/365 (April 30-August 30, 1955) of the real property tax paid July 1, 1955, for the 1955 real property tax year is treated as imposed on D and may be deducted by him. Under the provisions of section 164(d)(1), 123/365 (August 31-December 31, 1955) of the real property tax due and paid on July 1, 1955, for the 1955 real property tax year is treated as imposed on E and, under the provisions of section 164(d)(2)(A) such portion is treated as having been paid by him on the date of sale.

Example (3). In State X the real property tax year is the calendar year. The real property tax becomes a lien on November 1 of the preceding calendar year. On November 15, 1955, F sells real property in State X to G. G owns the real property through December 31, 1956. Under section 164(d)(1), the real property tax (which became a lien on November 1, 1954) for the 1955 real property tax year is apportioned between F and G. No part of the real property tax for the 1956 real property tax year may be deducted by F. The entire real property tax for the 1956 real property tax year may be deducted by G when paid or accrued, depending upon the method of accounting used by him. See subparagraph (6) of paragraph (d) and section 461(c) and the regulations thereunder.

(c) *Real property tax year.* As used in section 164(d), the term "real property tax year" refers to the period which, under the law imposing the tax, is regarded as the period to which the tax imposed relates. Where the State and one or more local governmental units each imposes a tax on real property, the real property tax year for each tax must be determined for purposes of applying the rule of apportionment of section 164(d)(1) to each tax. The time when the tax rate is determined, the time when the assessment is made, the time when the tax becomes a lien, or the time when the tax becomes due or delinquent does not necessarily determine the real property tax year. The real property tax year may or may not correspond to the fiscal year of the governmental unit imposing the tax. In each case the State or local law determines what constitutes the real property tax year. Although the seller and the purchaser may or may not make an allocation of real property taxes, the meaning of "real property tax year" in section 164(d) and the application of section 164(d) do not depend upon what real property taxes were allocated nor the method of allocation used by the parties.

(d) *Special rules*—(1) *Seller using cash receipts and disbursements method of accounting.* Under the provisions of section 164(d), if the seller by reason of his method of accounting may not deduct any amount for taxes unless paid, and—

(i) The purchaser (under the law imposing the real property tax) is liable for the real property tax for the real property tax year, or

(ii) The seller (under the law imposing the real property tax) is liable for the real property tax for the real property tax year and the tax is not payable until after the date of sale,

then the portion of the tax treated under section 164(d)(1) as imposed upon the seller (whether or not actually paid by him in the taxable year in which the sale occurs) shall be considered as having been paid by him in such taxable year. Such portion may be deducted by him for the taxable year in which the sale occurs, or, if at a later time, for the taxable year (which would be proper under the taxpayer's method of accounting) in which the tax is actually paid, or an amount representing such tax is paid to the purchaser, mortgagee, trustee, or other person having an interest in the property as security.

(2) *Purchasers using the cash receipts and disbursements method of accounting.* Under the provisions of section 164(d), if the purchaser by reason of his method of accounting may not deduct any amount for taxes unless paid and the seller (under the law imposing the real property tax) is liable for the real property tax for the real property tax year, the portion of the tax treated under section 164(d)(1) as imposed upon the purchaser (whether or not actually paid by him in the taxable year in which the sale occurs) shall be considered as having been paid by him in such taxable year. Such portion may be deducted by him for the taxable year in which the sale occurs, or, if at a later time, for the taxable year (which would be proper under the taxpayer's method of accounting) in which the tax is actually paid, or an amount representing such tax is paid to the seller, mortgagee, trustee, or other person having an interest in the property as security.

(3) *Persons considered liable for tax.* Where the tax is not a liability of any person, the person who holds the property at the time the tax becomes a lien on the property shall be considered liable for the tax. As to a particular sale, in determining:

(i) Whether the other party to the sale is liable for the tax or,

(ii) The person who holds the property at the time the tax becomes a lien on the property (where the tax is not a liability of any person),

prior or subsequent sales of the property during the real property tax year shall be disregarded.

(4) *Examples.* The provisions of subparagraphs (1), (2), and (3) of this paragraph may be illustrated as follows:

Example (1). In County X the real property tax year is the calendar year. The real property tax is a personal liability of the owner of the real property on June 30 of the current real property tax year, but is not payable until February 28 of the following real property tax year. A, the owner of real property in County X on January 1, 1955, uses the cash receipts and disbursements method of accounting. On May 30, 1955, A sells the real property to B, who also uses the cash receipts and disbursements method of accounting. B retains ownership of the real property for the balance of the 1955 calendar year. Under the provisions of section 164(d)(1), 149/365 (January 1–May 29, 1955) of the real property tax payable on February 28, 1956, for the 1955 real property tax year is treated as imposed on A, the seller, and under the provisions of section 164(d)(2)(A) such portion is treated as having been paid by him on the date of sale and may be deducted by him for his taxable year in which the sale occurs (whether or not such portion is actually paid by him in that year) or for his taxable year in which the tax is actually paid or an amount representing such tax is paid. Under the provisions of section 164(d)(1), 216/365 (May 30–December 31, 1955) of the real property tax payable on February 28, 1956, for the 1955 real property tax year is treated as imposed on B, the purchaser, and may be deducted by him for his taxable year in which the tax is actually paid, or an amount representing such tax is paid.

Example (2). In County Y, the real property tax year is the calendar year. The real property tax becomes a lien on January 1, 1955, and is payable on April 30, 1955. There is no personal liability for the real property tax imposed by County Y. On April 30, 1955, C, the owner of real property in County Y on January 1, 1955, pays the real property tax for the 1955 real property tax year. On May 1, 1955, C sells the real property to D. On September 1, 1955, D sells the real property to E. C, D, and E use the cash receipts and disbursements method of accounting. Under the provisions of section 164(d)(1), 120/365 (January 1–April 30, 1955) of the real property tax is treated as imposed upon C and may be deducted by him for his taxable year in which the tax is actually paid. Under section 164(d)(1), 123/365 (May 1–August 31, 1955) of the real property tax is treated as imposed upon D and, under the provisions of section 164(d)(2)(A), is treated as having been paid by him on May 1, 1955, and may be deducted by D for his taxable year in which the sale from C to him occurs

(whether or not such portion is actually paid by him in that year), or for his taxable year in which an amount representing such tax is paid. Since, according to paragraph (d)(3) of this section, the prior sale by C to D is disregarded, under the provisions of section 164(d)(1), 122/365 (September 1–December 31, 1955) of the real property tax is treated as imposed on E and, under the provisions of section 164(d)(2)(A), is treated as having been paid by him on September 1, 1955, and may be deducted by E for his taxable year in which the sale from D to him occurs (whether or not such portion is actually paid by him in that year), or for his taxable year in which an amount representing such tax is paid.

Example (3). In County X the real property tax year is the calendar year and the real property taxes are assessed and become a lien on June 30 of the current real property tax year, but are not payable until September 1 of that year. There is no personal liability for the real property tax imposed by County X. A, the owner on January 1, 1955, of real property in County X, uses the cash receipts and disbursements method of accounting. On July 15, 1955, A sells the real property to B. Under the provisions of section 164(d)(1), 195/365 (January 1–July 14, 1955) of the real property tax payable on September 1, 1955, for the 1955 real property tax year is treated as imposed on A, and may be deducted by him for his taxable year in which the sale occurs (whether or not such portion is actually paid by him in that year) or for his taxable year in which the tax is actually paid or an amount representing such tax is paid. Under the provisions of section 164(d)(1), 170/365 (July 15–December 31, 1955) of the real property tax is treated as imposed on B and may be deducted by him for his taxable year in which the sale occurs (whether or not such portion is actually paid by him in that year), or for his taxable year in which the tax is actually paid or an amount representing such tax is paid.

(5) *Treatment of excess deduction.* If, for a taxable year prior to the taxable year of sale of real property, a taxpayer has deducted an amount for real property tax in excess of the portion of such real property tax treated as imposed on him under the provisions of section 164(d), the excess of the amount deducted over the portion treated as imposed on him shall be included in his gross income for the taxable year of the sale, subject to the provisions of section 111, relating to the recovery of bad debts, prior taxes, and delinquency amounts. The provisions of this subparagraph may be illustrated as follows:

Example (1). In Borough Y the real property tax is due and payable on November 30 for the succeeding calendar year, which is also the real property tax year. On November 30, 1954, taxpayer A, who reports his income on a calendar year under the cash receipts and disbursements method of accounting, pays the real property tax on real property owned by him in Borough Y for the 1955 real property tax year. On June 30, 1955, A sells the real property. Under the provisions of section 164(d), only 180/365 (January 1–June 29, 1955) of the real property tax for the 1955 real property tax year is treated as imposed on A, and the excess of the amount of real property tax for 1955 deducted by A on his 1954 income tax return, over the 180/365 portion of such tax treated as imposed on him under section 164(d), must be included in gross income in A's 1955 income tax return, subject to the provisions of section 111.

Example (2). In County Z the real property tax year is the calendar year. The real property tax becomes a personal liability of the owner of real property on January 1 of the current real property tax year, and is payable on July 1 of the current real property tax year. On May 1, 1955, A, the owner of real property in County Z on January 1, 1955, sells the real property to B. On November 1, 1955, B sells the same real property to C. B uses the cash receipts and disbursements method of accounting and reports his income on the basis of a fiscal year ending July 31. B, on July 1, 1955, pays the entire real property tax for the real property tax year ending December 31, 1955. Under the provisions of section 164(d), only 184/365 (May 1–October 31, 1955) of the real property tax for the 1955 real property tax year is treated as imposed on B, and the excess of the amount of real property tax for 1955 deducted by B on his income tax return for the fiscal year ending July 31, 1955, over the 184/365 portion of such tax treated as imposed on him under section 164(d), must be included in gross income in B's income tax return for his fiscal year ending July 31, 1956, subject to the provisions of section 111.

(6) *Persons using an accrual method of accounting.* Where real property is sold and the seller or the purchaser computes his taxable income (for the taxable year during which the sale occurs) on an accrual method of accounting then, if the seller or the purchaser has not made the election provided in section 461(c) (relating to the accrual of real property taxes), the

portion of any real property tax which is treated as imposed on him and which may not be deducted by him for any taxable year by reason of his method of accounting shall be treated as having accrued on the date of sale. The provisions of this subparagraph may be illustrated as follows:

Example. In County X the real property tax becomes a lien on property and is assessed on November 30 for the current calendar year, which is also the real property tax year. There is no personal liability for the real property tax imposed by County X. A owns, on January 1, 1955, real property in County X. A uses an accrual method of accounting and has not made any election under section 461(c) to accrue ratably real property taxes. A sells real property on June 30, 1955. By reason of A's method of accounting, he could not deduct any part of the real property tax for 1955 on the real property since he sold the real property prior to November 30, 1955, the accrual date. Under section 164(d)(1), 180/365 (January 1–June 29, 1955) of the real property tax for the 1955 real property tax year is treated as imposed on A, and under section 164(d)(2)(D) that portion is treated as having accrued on June 30, 1955, and may be deducted by A for his taxable year in which such date falls. B, the purchaser from A, who uses an accrual method of accounting, has likewise not made an election under section 461(c) to accrue real property taxes ratably. Under section 164(d)(1), 185/365 of the real property taxes may be accrued by B on November 30, 1955, and deducted for his taxable year in which such date falls.

(7) *Cross references.* For determination of amount realized on a sale of real property, see section 1001(b) and the regulations thereunder. For determination of basis of real property acquired by purchase, see section 1012 and the regulations thereunder.

(8) *Effective dates.* Section 164(d) applies to taxable years ending after December 31, 1953, but only in the case of sales made after December 31, 1953. However, section 164(d) does not apply to any real property tax to the extent that such tax was allowable as a deduction under the Internal Revenue Code of 1939 to the seller for any taxable year which ended before January 1, 1954.

§ 1.164–7 Taxes of shareholder paid by corporation.

Banks and other corporations paying taxes assessed against their shareholders on account of their ownership of the shares of stock issued by such corporations without reimbursement from such shareholders may deduct the amount of taxes so paid. In such cases no deduction shall be allowed to the shareholders for such taxes. The amount so paid should not be included in the gross income of the shareholder.

§ 1.164–8 Payments for municipal services in atomic energy communities.

(a) *General.* For taxable years beginning after December 31, 1957, amounts paid or accrued by any owner of real property within any community (as defined in section 21b of the Atomic Energy Community Act of 1955 (42 U.S.C. 2304)) to compensate the Atomic Energy Commission for municipal-type services (or any agent or contractor authorized by the Atomic Energy Commission to charge for such services) shall be treated as State real property taxes paid or accrued for purposes of section 164. Such amounts shall be deductible as taxes to the extent provided in section 164, §§ 1.164–1 through 1.164–7, and this section. See paragraph (b) of this section for definition of the term "Atomic Energy Commission"; paragraph (c) of this section for the definition of the term "municipal-type services"; and paragraph (d) of this section for the definition of the term "owner".

(b) *Atomic Energy Commission.* For purposes of paragraph (a) of this section, the term "Atomic Energy Commission" shall mean—

(1) The Atomic Energy Commission, and

(2) Any other agency of the United States Government to which the duties and responsibilities of providing municipal-type services are delegated under the authority of section 101 of the Atomic Energy Community Act of 1955 (42 U.S.C. 2313).

(c) *Municipal-type services.* For purposes of paragraph (a) of this section, the term "municipal-type services" includes services usually rendered by a municipality and usually paid for by taxes. Examples of municipal-type services are police protection, fire protection, public recreational facilities,

public libraries, public schools, public health, public welfare, and the maintenance of roads and streets. The term shall include sewage and refuse disposal which are maintained out of revenues derived from a general charge for municipal-type services; however, the term shall not include sewage and refuse disposal if a separate charge for such services is made. Charges assessed against local benefits of a kind tending to increase the value of the property assessed are not charges for municipal-type services. See section 164(c)(1) and § 1.164–4.

(d) *Owner.* For purposes of paragraph (a) of this section, the term "owner" includes a person who holds the real property under a leasehold of 40 or more years from the Atomic Energy Commission (or any agency of the United States Government to which the duties and responsibilities of leasing real property are delegated under section 101 of the Atomic Energy Community Act of 1955), and a person who has entered into a contract to purchase under section 61 of the Atomic Energy Community Act of 1955 (42 U.S.C. 2361). An assignee (either immediate or more remote) of a lessee referred to in the preceding sentence will also qualify as an owner for purposes of paragraph (a) of this section.

(e) *Nonapplication of section 164(d).* Section 164(d) and § 1.164–6, relating to apportionment of taxes on real property between seller and purchaser, do not apply to a sale by the United States or any of its agencies of real property to which section 164(f) and this section apply. Thus, amounts paid or accrued which qualify under paragraph (a) of this section will continue to be deductible as taxes to the extent provided in this section, even in the taxable year in which the owner actually purchases the real property from the United States or any of its agencies. However, the provisions of section 164(d) and § 1.164–6 shall apply to a sale of real property to which section 164(f) and this section apply, if the seller is other than the United States or any of its agencies.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6789, 29 FR 18147, Dec. 22, 1964]

§ 1.165–1 Losses.

(a) *Allowance of deduction.* Section 165(a) provides that, in computing taxable income under section 63, any loss actually sustained during the taxable year and not made good by insurance or some other form of compensation shall be allowed as a deduction subject to any provision of the internal revenue laws which prohibits or limits the amount of the deduction. This deduction for losses sustained shall be taken in accordance with section 165 and the regulations thereunder. For the disallowance of deductions for worthless securities issued by a political party, see § 1.271–1.

(b) *Nature of loss allowable.* To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and § 1.165–11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

(c) *Amount deductible.* (1) The amount of loss allowable as a deduction under section 165(a) shall not exceed the amount prescribed by § 1.1011–1 as the adjusted basis for determining the loss from the sale or other disposition of the property involved. In the case of each such deduction claimed, therefore, the basis of the property must be properly adjusted as prescribed by § 1.1011–1 for such items as expenditures, receipts, or losses, properly chargeable to capital account, and for such items as depreciation, obsolescence, amortization, and depletion, in order to determine the amount of loss allowable as a deduction. To determine the allowable loss in the case of property acquired before March 1, 1913, see also paragraph (b) of § 1.1053–1.

(2) The amount of loss recognized upon the sale or exchange of property shall be determined for purposes of section 165(a) in accordance with § 1.1002–1.

(3) A loss from the sale or exchange of a capital asset shall be allowed as a deduction under section 165(a) but

only to the extent allowed in section 1211 (relating to limitation on capital losses) and section 1212 (relating to capital loss carrybacks and carryovers), and in the regulations under those sections.

(4) In determining the amount of loss actually sustained for purposes of section 165(a), proper adjustment shall be made for any salvage value and for any insurance or other compensation received.

(d) *Year of deduction.* (1) A loss shall be allowed as a deduction under section 165(a) only for the taxable year in which the loss is sustained. For this purpose, a loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. For provisions relating to situations where a loss attributable to a disaster will be treated as sustained in the taxable year immediately preceding the taxable year in which the disaster actually occurred, see section 165(h) and § 1.165-11.

(2) (i) If a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances. Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim. When a taxpayer claims that the taxable year in which a loss is sustained is fixed by his abandonment of the claim for reimbursement, he must be able to produce objective evidence of his having abandoned the claim, such as the execution of a release.

(ii) If in the year of the casualty or other event a portion of the loss is not covered by a claim for reimbursement with respect to which there is a reasonable prospect of recovery, then such portion of the loss is sustained during the taxable year in which the casualty or other event occurs. For example, if property having an adjusted basis of $10,000 is completely destroyed by fire in 1961, and if the taxpayer's only claim for reimbursement consists of an insurance claim for $8,000 which is settled in 1962, the taxpayer sustains a loss of $2,000 in 1961. However, if the taxpayer's automobile is completely destroyed in 1961 as a result of the negligence of another person and there exists a reasonable prospect of recovery on a claim for the full value of the automobile against such person, the taxpayer does not sustain any loss until the taxable year in which the claim is adjudicated or otherwise settled. If the automobile had an adjusted basis of $5,000 and the taxpayer secures a judgment of $4,000 in 1962, $1,000 is deductible for the taxable year 1962. If in 1963 it becomes reasonably certain that only $3,500 can ever be collected on such judgment, $500 is deductible for the taxable year 1963.

(iii) If the taxpayer deducted a loss in accordance with the provisions of this paragraph and in a subsequent taxable year receives reimbursement for such loss, he does not recompute the tax for the taxable year in which the deduction was taken but includes the amount of such reimbursement in his gross income for the taxable year in which received, subject to the provisions of section 111, relating to recovery of amounts previously deducted.

(3) Any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers the loss (see § 1.165-8, relating to theft losses). However, if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until the taxable year in which it can be ascertained with rea-

sonable certainty whether or not such reimbursement will be received.

(4) The rules of this paragraph are applicable with respect to a casualty or other event which may result in a loss and which occurs after January 16, 1960. If the casualty or other event occurs on or before such date, a taxpayer may treat any loss resulting therefrom in accordance with the rules then applicable, or, if he so desires, in accordance with the provisions of this paragraph; but no provision of this paragraph shall be construed to permit a deduction of the same loss or any part thereof in more than one taxable year or to extend the period of limitations within which a claim for credit or refund may be filed under section 6511.

(e) *Limitation on losses of individuals.* In the case of an individual, the deduction for losses granted by section 165(a) shall, subject to the provisions of section 165(c) and paragraph (a) of this section, be limited to:

(1) Losses incurred in a trade or business;

(2) Losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) Losses of property not connected with a trade or business and not incurred in any transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other causalty, or from theft, and if the loss involved has not been allowed for estate tax purposes in the estate tax return. For additional provisions pertaining to the allowance of casualty and theft losses, see §§ 1.165-7 and 1.165-8, respectively.

For special rules relating to an election by a taxpayer to deduct disaster losses in the taxable year immediately preceding the taxable year in which the disaster occurred, see section 165(h) and § 1.165-11.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6735, 29 FR 6493, May 19, 1964; T.D. 6996, 34 FR 835, Jan. 18, 1969; T.D. 7301, 39 FR 963, Jan. 4, 1974; T.D. 7522, 42 FR 63411, Dec. 16, 1977]

§ 1.165-2 Obsolescence of nondepreciable property.

(a) *Allowance of deduction.* A loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually sustained. For this purpose, the taxable year in which the loss is sustained is not necessarily the taxable year in which the overt act of abandonment, or the loss of title to the property, occurs.

(b) *Exceptions.* This section does not apply to losses sustained upon the sale or exchange of property, losses sustained upon the obsolescence or worthlessness of depreciable property, casualty losses, or losses reflected in inventories required to be taken under section 471. The limitations contained in sections 1211 and 1212 upon losses from the sale or exchange of capital assets do not apply to losses allowable under this section.

(c) *Cross references.* For the allowance under section 165(a) of losses arising from the permanent withdrawal of depreciable property from use in the trade or business or in the production of income, see § 1.167(a)-8. For provisions respecting the obsolescence of depreciable property, see § 1.167(a)-9. For the allowance of casualty losses, see § 1.165-7.

§ 1.165-3 Demolition of buildings.

(a) *Intent to demolish formed at time of purchase.* (1) Except as provided in subparagraph (2) of this paragraph, the following rule shall apply when, in the course of a trade or business or in a transaction entered into for profit, real property is purchased with the intention of demolishing either immediately or subsequently the buildings situated thereon: No deduction shall be allowed under section 165(a) on account of the demolition of the old buildings even though any demolition originally planned is subse-

quently deferred or abandoned. The entire basis of the property so purchased shall, notwithstanding the provisions of § 1.167(a)–5, be allocated to the land only. Such basis shall be increased by the net cost of demolition or decreased by the net proceeds from demolition.

(2) (i) If the property is purchased with the intention of demolishing the buildings and the buildings are used in a trade or business or held for the production of income before their demolition, a portion of the basis of the property may be allocated to such buildings and depreciated over the period during which they are so used or held. The fact that the taxpayer intends to demolish the buildings shall be taken into account in making the apportionment of basis between the land and buildings under § 1.167(a)–5. In any event, the portion of the purchase price which may be allocated to the buildings shall not exceed the present value of the right to receive rentals from the buildings over the period of their intended use. The present value of such right shall be determined at the time that the buildings are first used in the trade or business or first held for the production of income. If the taxpayer does not rent the buildings, but uses them in his own trade or business or in the production of his income, the present value of such right shall be determined by reference to the rentals which could be realized during such period of intended use. The fact that the taxpayer intends to rent or use the buildings for a limited period before their demolition shall also be taken into account in computing the useful life in accordance with paragraph (b) of § 1.167(a)–1.

(ii) Any portion of the purchase price which is allocated to the buildings in accordance with this subparagraph shall not be included in the basis of the land computed under subparagraph (1) of this paragraph, and any portion of the basis of the buildings which has not been recovered through depreciation or otherwise at the time of the demolition of the buildings is allowable as a deduction under section 165.

(iii) The application of this subparagraph may be illustrated by the following example:

Example. In January 1958, A purchased land and a building for $60,000 with the intention of demolishing the building. In the following April, A concludes that he will be unable to commence the construction of a proposed new building for a period of more than 3 years. Accordingly, on June 1, 1958, he leased the building for a period of 3 years at an annual rental of $1,200. A intends to demolish the building upon expiration of the lease. A may allocate a portion of the $60,000 basis of the property to the building to be depreciated over the 3-year period. That portion is equal to the present value of the right to receive $3,600 (3 times $1,200). Assuming that the present value of that right determined as of June 1, 1958, is $2,850, A may allocate that amount to the building and, if A files his return on the basis of a taxable year ending May 31, 1959, A may take a depreciation deduction with respect to such building of $950 for such taxable year. The basis of the land to A as determined under subparagraph (1) of this paragraph is reduced by $2,850. If on June 1, 1960, A ceases to rent the building and demolishes it, the balance of the undepreciated portion allocated to the buildings, $950, may be deducted from gross income under section 165.

(3) The basis of any building acquired in replacement of the old buildings shall not include any part of the basis of the property originally purchased even though such part was, at the time of purchase, allocated to the buildings to be demolished for purposes of determining allowable depreciation for the period before demolition.

(b) *Intent to demolish formed subsequent to the time of acquisition.* (1) Except as provided in subparagraph (2) of this paragraph, the loss incurred in a trade or business or in a transaction entered into for profit and arising from a demolition of old buildings shall be allowed as a deduction under section 165(a) if the demolition occurs as a result of a plan formed subsequent to the acquisition of the buildings demolished. The amount of the loss shall be the adjusted basis of the buildings demolished increased by the net cost of demolition or decreased by the net proceeds from demolition. See paragraph (c) of § 1.165–1 relating to amount deductible under section 165.

The basis of any building acquired in replacement of the old buildings shall not include any part of the basis of the property demolished.

(2) If a lessor or lessee of real property demolishes the buildings situated thereon pursuant to a lease or an agreement which resulted in a lease, under which either the lessor was required or the lessee was required or permitted to demolish such buildings, no deduction shall be allowed to the lessor under section 165(a) on account of the demolition of the old buildings. However, the adjusted basis of the demolished buildings, increased by the net cost of demolition or decreased by the net proceeds from demolition, shall be considered as a part of the cost of the lease to be amortized over the remaining term thereof.

(c) *Evidence of intention.* (1) Whether real property has been purchased with the intention of demolishing the buildings thereon or whether the demolition of the buildings occurs as a result of a plan formed subsequent to their acquisition is a question of fact, and the answer depends upon an examination of all the surrounding facts and circumstances. The answer to the question does not depend solely upon the statements of the taxpayer at the time he acquired the property or demolished the buildings, but such statements, if made, are relevant and will be considered. Certain other relevant facts and circumstances that exist in some cases and the inferences that might reasonably be drawn from them are described in subparagraphs (2) and (3) of this paragraph. The question as to the taxpayer's intention is not answered by any inference that is drawn from any one fact or circumstance but can be answered only by a consideration of all relevant facts and circumstances and the reasonable inferences to be drawn therefrom.

(2) An intention at the time of acquisition to demolish may be suggested by:

(i) A short delay between the date of acquisition and the date of demolition;

(ii) Evidence of prohibitive remodeling costs determined at the time of acquisition;

(iii) Existence of municipal regulations at the time of acquisition which would prohibit the continued use of the buildings for profit purposes;

(iv) Unsuitability of the buildings for the taxpayer's trade or business at the time of acquisition; or

(v) Inability at the time of acquisition to realize a reasonable income from the buildings.

(3) The fact that the demolition occurred pursuant to a plan formed subsequent to the acquisition of the property may be suggested by:

(i) Substantial improvement of the buildings immediately after their acquisition;

(ii) Prolonged use of the buildings for business purposes after their acquisition;

(iii) Suitability of the buildings for investment purposes at the time of acquisition;

(iv) Substantial change in economic or business conditions after the date of acquisition;

(v) Loss of useful value occurring after the date of acquisition;

(vi) Substantial damage to the buildings occurring after their acquisition;

(vii) Discovery of latent structural defects in the buildings after their acquisition;

(viii) Decline in the taxpayer's business after the date of acquisition;

(ix) Condemnation of the property by municipal authorities after the date of acquisition; or

(x) Inability after acquisition to obtain building material necessary for the improvement of the property.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 74474, 41 FR 55710, Dec. 22, 1976]

§ 1.165–4 Decline in value of stock.

(a) *Deduction disallowed.* No deduction shall be allowed under section 165(a) solely on account of a decline in the value of stock owned by the taxpayer when the decline is due to a fluctuation in the market price of the stock or to other similar cause. A mere shrinkage in the value of stock owned by the taxpayer, even though extensive, does not give rise to a deduction under section 165(a) if the stock has any recognizable value on the date claimed as the date of loss. No loss for a decline in the value of stock owned

by the taxpayer shall be allowed as a deduction under section 165(a) except insofar as the loss is recognized under § 1.1002-1 upon the sale or exchange of the stock and except as otherwise provided in § 1.165-5 with respect to stock which becomes worthless during the taxable year.

(b) *Stock owned by banks.* (1) In the regulation of banks and certain other corporations, Federal and State authorities may require that stock owned by such organizations be charged off as worthless or written down to a nominal value. If, in any such case, this requirement is premised upon the worthlessness of the stock, the charging off or writing down will be considered prima facie evidence of worthlessness for purposes of section 165(a); but, if the charging off or writing down is due to a fluctuation in the market price of the stock or if no reasonable attempt to determine the worthlessness of the stock has been made, then no deduction shall be allowed under section 165(a) for the amount so charged off or written down.

(2) This paragraph shall not be construed, however, to permit a deduction under section 165(a) unless the stock owned by the bank or other corporation actually becomes worthless in the taxable year. Such a taxpayer owning stock which becomes worthless during the taxable year is not precluded from deducting the loss under section 165(a) merely because, in obedience to the specific orders or general policy of such supervisory authorities, the value of the stock is written down to a nominal amount instead of being charged off completely.

(c) *Application to inventories.* This section does not apply to a decline in the value of corporate stock reflected in inventories required to be taken by a dealer in securities under section 471. See § 1.471-5.

(d) *Definition.* As used in this section, the term "stock" means a share of stock in a corporation or a right to subscribe for, or to receive, a share of stock in a corporation.

§ 1.165-5 Worthless securities.

(a) *Definition of security.* As used in section 165(g) and this section, the term "security" means:

(1) A share of stock in a corporation;

(2) A right to subscribe for, or to receive, a share of stock in a corporation; or

(3) A bond, debenture, note, or certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money, which has been issued with interest coupons or in registered form by a domestic or foreign corporation or by any government or political subdivision thereof.

(b) *Ordinary loss.* If any security which is not a capital asset becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss.

(c) *Capital loss.* If any security which is a capital asset becomes wholly worthless at any time during the taxable year, the loss resulting therefrom may be deducted under section 165(a) but only as though it were a loss from a sale or exchange, on the last day of the taxable year, of a capital asset. See section 165(g)(1). The amount so allowed as a deduction shall be subject to the limitations upon capital losses described in paragraph (c)(3) of § 1.165-1.

(d) *Loss on worthless securities of an affiliated corporation*—(1) *Deductible as an ordinary loss.* If a taxpayer which is a domestic corporation owns any security of a domestic or foreign corporation which is affiliated with the taxpayer within the meaning of subparagraph (2) of this paragraph and such security becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss in accordance with paragraph (b) of this section. The fact that the security is in fact a capital asset of the taxpayer is immaterial for this purpose, since section 165(g)(3) provides that such security shall be treated as though it were not a capital asset for the purposes of section 165(g)(1). A debt which becomes wholly worthless during the taxable year shall be as an ordinary loss in ac-

cordance with the provisions of this subparagraph, to the extent that such debt is a security within the meaning of paragraph (a)(3) of this section.

(2) *Affiliated corporation defined.* For purposes of this paragraph, a corporation shall be treated as affiliated with the taxpayer owning the security if—

(i)(*a*) In the case of a taxable year beginning on or after January 1, 1970, the taxpayer owns directly—

(*1*) Stock possessing at least 80 percent of the voting power of all classes of such corporation's stock, and

(*2*) At least 80 percent of each class of such corporation's nonvoting stock excluding for purposes of this subdivision (i)(*a*) nonvoting stock which is limited and preferred as to dividends (see section 1504(a)), or

(*b*) In the case of a taxable year beginning before January 1, 1970, the taxpayer owns directly at least 95 percent of each class of the stock of such corporation;

(ii) None of the stock of such corporation was acquired by the taxpayer solely for the purpose of converting a capital loss sustained by reason of the worthlessness of any such stock into an ordinary loss under section 165(g)(3), and

(iii) More than 90 percent of the aggregate of the gross receipts of such corporation for all the taxable years during which it has been in existence has been from sources other than royalties, rents (except rents derived from rental of properties to employees of such corporation in the ordinary course of its operating business), dividends, interest (except interest received on the deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities. For this purpose, the term "gross receipts" means total receipts determined without any deduction for cost of goods sold, and gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains from such sales or exchanges.

(e) *Bonds issued by an insolvent corporation.* A bond of an insolvent corporation secured only by a mortgage from which nothing is realized for the bondholders on foreclosure shall be regarded as having become worthless not later than the year of the foreclosure sale, and no deduction in respect of the loss shall be allowed under section 165(a) in computing a bondholder's taxable income for a subsequent year. See also paragraph (d) of § 1.165–1.

(f) *Decline in market value.* A taxpayer possessing a security to which this section relates shall not be allowed any deduction under section 165(a) on account of mere market fluctuation in the value of such security. See also § 1.165–4.

(g) *Application to inventories.* This section does not apply to any loss upon the worthlessness of any security reflected in inventories required to be taken by a dealer in securities under section 471. See § 1.471–5.

(h) *Special rules for banks.* For special rules applicable under this section to worthless securities of a bank, including securities issued by an affiliated bank, see § 1.582–1.

(i) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). (i) X Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 100 percent of each class of the stock of Y Corporation; and, in addition, 19 percent of the common stock (the only class of stock) of Z Corporation, which it acquired in 1948. Y Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 81 percent of the common stock of Z Corporation, which it acquired in 1946. It is established that the stock of Z Corporation, which has from its inception derived all of its gross receipts from manufacturing operations, became worthless during 1971.

(ii) Since the stock of Z Corporation which is owned by X Corporation is a capital asset and since X Corporation does not directly own at least 80 percent of the stock of Z Corporation, any loss sustained by X Corporation upon the worthlessness of such stock shall be deducted under section 165(g)(1) and paragraph (c) of this section as a loss from a sale or exchange on December 31, 1971, of a capital asset. The loss so sustained by X Corporation shall be considered a long-term capital loss under the provisions of section 1222(4), since the stock was held by that corporation for more than 6 months.

(iii) Since Z Corporation is considered to be affiliated with Y Corporation under the

provisions of paragraph (d)(2) of this section, any loss sustained by Y Corporation upon the worthlessness of the stock of Z Corporation shall be deducted in 1971 under section 165(g)(3) and paragraph (d)(1) of this section as an ordinary loss.

Example (2). (i) On January 1, 1971, X Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 60 percent of each class of the stock of Y Corporation, a foreign corporation, which it acquired in 1950. Y Corporation has, from the date of its incorporation, derived all of its gross receipts from manufacturing operations. It is established that the stock of Y Corporation became worthless on June 30, 1971. On August 1, 1971, X Corporation acquires the balance of the stock of Y Corporation for the purpose of obtaining the benefit of section 165(g)(3) with respect to the loss it has sustained on the worthlessness of the stock of Y Corporation.

(ii) Since the stock of Y Corporation which is owned by X Corporation is a capital asset and since Y Corporation is not to be treated as affiliated with X Corporation under the provisions of paragraph (d)(2) of this section, notwithstanding the fact that, at the close of 1971, X Corporation owns 100 percent of each class of stock of Y Corporation, any loss sustained by X Corporation upon the worthlessness of such stock shall be deducted under the provisions of section 165(g)(1) and paragraph (c) of this section as a loss from a sale or exchange on December 31, 1971, of a capital asset.

Example (3). (i) X Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 80 percent of each class of the stock of Y Corporation, which from its inception has derived all of its gross receipts from manufacturing operations. As one of its capital assets, X Corporation owns $100,000 in registered bonds issued by Y Corporation payable at maturity on December 31, 1974. It is established that these bonds became worthless during 1971.

(ii) Since Y Corporation is considered to be affiliated with X Corporation under the provisions of paragraph (d)(2) of this section, any loss sustained by X Corporation upon the worthlessness of these bonds may be deducted in 1971 under section 165(g)(3) and paragraph (d)(1) of this section as an ordinary loss. The loss may not be deducted under section 166 as a bad debt. See section 166(e).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7224, 37 FR 25928, Dec. 6, 1972]

§ 1.165–6 Farming losses.

(a) *Allowance of losses.* (1) Except as otherwise provided in this section, any loss incurred in the operation of a farm as a trade or business shall be allowed as a deduction under section 165(a) or as a net operating loss deduction in accordance with the provisions of section 172. See § 1.172–1.

(2) If the taxpayer owns and operates a farm for profit in addition to being engaged in another trade or business, but sustains a loss from the operation of the farming business, then the amount of loss sustained in the operation of the farm may be deducted from gross income, if any, from all other sources.

(3) Loss incurred in the operation of a farm for recreation or pleasure shall not be allowed as a deduction from gross income. See § 1.162–12.

(b) *Loss from shrinkage.* If, in the course of the business of farming, farm products are held for a favorable market, no deduction shall be allowed under section 165(a) in respect of such products merely because of shrinkage in weight, decline in value, or deterioration in storage.

(c) *Loss of prospective crop.* The total loss by frost, storm, flood, or fire of a prospective crop being grown in the business of farming shall not be allowed as a deduction under section 165(a).

(d) *Loss of livestock*—(1) *Raised stock.* A taxpayer engaged in the business of raising and selling livestock, such as cattle, sheep, or horses, may not deduct as a loss under section 165(a) the value of animals that perish from among those which were raised on the farm.

(2) *Purchased stock.* The loss sustained upon the death by disease, exposure, or injury of any livestock purchased and used in the trade or business of farming shall be allowed as a deduction under section 165(a). See, also, paragraph (e) of this section.

(e) *Loss due to compliance with orders of governmental authority.* The loss sustained upon the destruction by order of the United States, a State, or any other governmental authority, of any livestock, or other property, purchased and used in the trade or business of farming shall be allowed as a deduction under section 165(a).

(f) *Amount deductible*—(1) *Expenses of operation.* The cost of any feed,

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pasture, or care which is allowed under section 162 as an expense of operating a farm for profit shall not be included as a part of the cost of livestock for purposes of determining the amount of loss deductible under section 165(a) and this section. For the deduction of farming expenses, see § 1.162-12.

(2) *Losses reflected in inventories.* If inventories are taken into account in determining the income from the trade or business of farming, no deduction shall be allowed under this section for losses sustained during the taxable year upon livestock or other products, whether purchased for resale or produced on the farm, to the extent such losses are reflected in the inventory on hand at the close of the taxable year. Nothing in this section shall be construed to disallow the deduction of any loss reflected in the inventories of the taxpayer. For provisions relating to inventories of farmers, see section 471 and the regulations thereunder.

(3) *Other limitations.* For other provisions relating to the amount deductible under this section, see paragraph (c) of § 1.165-1, relating to the amount deductible under section 165(a); § 1.165-7, relating to casualty losses; and § 1.1231-1, relating to gains and losses from the sale or exchange of certain property used in the trade or business.

(g) *Other provisions applicable to farmers.* For other provisions relating to farmers, see § 1.61-4, relating to gross income of farmers; paragraph (b) of § 1.167(a)-6, relating to depreciation in the case of farmers; and § 1.175-1, relating to soil and water conservation expenditures.

§ 1.165-7 Casualty losses.

(a) *In general—(1) Allowance of deduction.* Except as otherwise provided in paragraphs (b)(4) and (c) of this section, any loss arising from fire, storm, shipwreck, or other casualty is allowable as a deduction under section 165(a) for the taxable year in which the loss is sustained. However, see § 1.165-6, relating to farming losses, and § 1.165-11, relating to an election by a taxpayer to deduct disaster losses in the taxable year immediately preceding the taxable year in which the disaster occurred. The manner of determining the amount of a casualty loss allowable as a deduction in computing taxable income under section 63 is the same whether the loss has been incurred in a trade or business or in any transaction entered into for profit, or whether it has been a loss of property not connected with a trade or business and not incurred in any transaction entered into for profit. The amount of a casualty loss shall be determined in accordance with paragraph (b) of this section. For other rules relating to the treatment of deductible casualty losses, see § 1.1231-1, relating to the involuntary conversion of property.

(2) *Method of valuation.* (i) In determining the amount of loss deductible under this section, the fair market value of the property immediately before and immediately after the casualty shall generally be ascertained by competent appraisal. This appraisal must recognize the effects of any general market decline affecting undamaged as well as damaged property which may occur simultaneously with the casualty, in order that any deduction under this section shall be limited to the actual loss resulting from damage to the property.

(ii) The cost of repairs to the property damaged is acceptable as evidence of the loss of value if the taxpayer shows that (*a*) the repairs are necessary to restore the property to its condition immediately before the casualty, (*b*) the amount spent for such repairs is not excessive, (*c*) the repairs do not care for more than the damage suffered, and (d) the value of the property after the repairs does not as a result of the repairs exceed the value of the property immediately before the casualty.

(3) *Damage to automobiles.* An automobile owned by the taxpayer, whether used for business purposes or maintained for recreation or pleasure, may be the subject of a casualty loss, including those losses specifically referred to in subparagraph (1) of this paragraph. In addition, a casualty loss occurs when an automobile owned by the taxpayer is damaged and when:

(i) The damage results from the faulty driving of the taxpayer or other person operating the automobile but is not due to the willful act or willful negligence of the taxpayer or of one acting in his behalf or

(ii) The damage results from the faulty driving of the operator of the vehicle with which the automobile of the taxpayer collides.

(4) *Application to inventories.* This section does not apply to a casualty loss reflected in the inventories of the taxpayer. For provisions relating to inventories, see section 471 and the regulations thereunder.

(5) *Property converted from personal use.* In the case of property which originally was not used in the trade or business or for income-producing purposes and which is thereafter converted to either of such uses, the fair market value of the property on the date of conversion, if less than the adjusted basis of the property at such time, shall be used, after making proper adjustments in respect of basis, as the basis for determining the amount of loss under paragraph (b)(1) of this section. See paragraph (b) of § 1.165–9, and § 1.167(g)–1.

(6) *Theft losses.* A loss which arises from theft is not considered a casualty loss for purposes of this section. See § 1.165–8, relating to theft losses.

(b) *Amount deductible*—(1) *General rule.* In the case of any casualty loss whether or not incurred in a trade or business or in any transaction entered into for profit, the amount of loss to be taken into account for purposes of section 165(a) shall be the lesser of either—

(i) The amount which is equal to the fair market value of the property immediately before the casualty reduced by the fair market value of the property immediately after the casualty; or

(ii) The amount of the adjusted basis prescribed in § 1.1011–1 for determining the loss from the sale or other disposition of the property involved.

However, if property used in a trade or business or held for the production of income is totally destroyed by casualty, and if the fair market value of such property immediately before the casualty is less than the adjusted basis of such property, the amount of the adjusted basis of such property shall be treated as the amount of the loss for purposes of section 165(a).

(2) *Aggregation of property for computing loss.* (i) A loss incurred in a trade or business or in any transaction entered into for profit shall be determined under subparagraph (1) of this paragraph by reference to the single, identifiable property damaged or destroyed. Thus, for example, in determining the fair market value of the property before and after the casualty in a case where damage by casualty has occurred to a building and ornamental or fruit trees used in a trade or business, the decrease in value shall be measured by taking the building and trees into account separately, and not together as an integral part of the realty, and separate losses shall be determined for such building and trees.

(ii) In determining a casualty loss involving real property and improvements thereon not used in a trade or business or in any transaction entered into for profit, the improvements (such as buildings and ornamental trees and shrubbery) to the property damaged or destroyed shall be considered an integral part of the property, for purposes of subparagraph (1) of this paragraph, and no separate basis need be apportioned to such improvements.

(3) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example (1). In 1956 B purchases for $3,600 an automobile which he uses for nonbusiness purposes. In 1959 the automobile is damaged in an accidental collision with another automobile. The fair market value of B's automobile is $2,000 immediately before the collision and $1,500 immediately after the collision. B receives insurance proceeds of $300 to cover the loss. The amount of the deduction allowable under section 165(a) for the taxable year 1959 is $200, computed as follows:

Value of automobile immediately before casualty	$2,000
Less: Value of automobile immediately after casualty	1,500
Value of property actually destroyed	500
Loss to be taken into account for purposes of section 165(a): Lesser amount of property actually destroyed ($500) or adjusted basis of property ($3,600)	500

Less: Insurance received	300
Deduction allowable	200

Example (2). In 1958 A purchases land containing an office building for the lump sum of $90,000. The purchase price is allocated between the land ($18,000) and the building ($72,000) for purposes of determining basis. After the purchase A planted trees and ornamental shrubs on the grounds surrounding the building. In 1961 the land, building, trees, and shrubs are damaged by hurricane. At the time of the casualty the adjusted basis of the land is $18,000 and the adjusted basis of the building is $66,000. At that time the trees and shrubs have an adjusted basis of $1,200. The fair market value of the land and building immediately before the casualty is $18,000 and $70,000, respectively, and immediately after the casualty is $18,000 and $52,000, respectively. The fair market value of the trees and shrubs immediately before the casualty is $2,000 and immediately after the casualty is $400. In 1961 insurance of $5,000 is received to cover the loss to the building. A has no other gains or losses in 1961 subject to section 1231 and § 1.1231-1. The amount of the deduction allowable under section 165(a) with respect to the building for the taxable year 1961 is $13,000, computed as follows:

Value of property immediately before casualty	$70,000
Less: Value of property immediately after casualty	52,000
Value of property actually destroyed	18,000
Less: Insurance received	5,000
Loss to be taken into account for purposes of section 165(a): Lesser amount of property actually destroyed ($18,000) or adjusted basis of property ($66,000)	18,000
Less: Insurance received	5,000
Deduction allowable	13,000

The amount of the deduction allowable under section 165(a) with respect to the trees and shrubs for the taxable year 1961 is $1,200, computed as follows:

Value of property immediately before casualty	$2,000
Less: Value of property immediately after casualty	$400
Value of property actually destroyed	1,600
Loss to be taken into account for purposes of section 165(a): Lesser amount of property actually destroyed ($1,600) or adjusted basis of property ($1,200)	1,200

Example (3). Assume the same facts as in example (2) except that A purchases land containing a house instead of an office building. The house is used as his private residence. Since the property is used for personal purposes, no allocation of the purchase price is necessary for the land and house. Likewise, no individual determination of the fair market values of the land, house, trees, and shrubs is necessary. The amount of the deduction allowable under section 165(a) with respect to the land, house, trees, and shrubs for the taxable year 1961 is $14,600, computed as follows:

Value of property immediately before casualty	$90,000
Less: Value of property immediately after casualty	70,400
Value of property actually destroyed	19,600
Loss to be taken into account for purposes of section 165(a): Lesser amount of property actually destroyed ($19,600) or adjusted basis of property ($91,200)	19,600
Less: Insurance received	5,000
Deduction allowable	14,600

(4) *Limitation on certain losses sustained by individuals after December 31, 1963.* (i) Pursuant to section 165(c)(3), the deduction allowable under section 165(a) in respect of a loss sustained—

(*a*) After December 31, 1963, in a taxable year ending after such date,

(*b*) In respect of property not used in a trade or business or for income producing purposes, and

(*c*) From a single casualty

shall be limited to that portion of the loss which is in excess of $100. The nondeductibility of the first $100 of loss applies to a loss sustained after December 31, 1963, without regard to when the casualty occurred. Thus, if property not used in a trade or business or for income producing purposes is damaged or destroyed by a casualty which occurred prior to January 1, 1964, and loss resulting therefrom is sustained after December 31, 1963, the $100 limitation applies.

(ii) The $100 limitation applies separately in respect of each casualty and applies to the entire loss sustained from each casualty. Thus, if as a result of a particular casualty occurring in 1964, a taxpayer sustains in 1964 a loss of $40 and in 1965 a loss of $250, no deduction is allowable for the loss sustained in 1964 and the loss sustained in 1965 must be reduced by $60 ($100−$40). The determination of whether damage to, or destruction of, property resulted from a single casualty or from two or more separate casualties will be made upon the basis of the particular facts of each case. However, events which are closely related

in origin generally give rise to a single casualty. For example, if a storm damages a taxpayer's residence and his automobile parked in his driveway, any loss sustained results from a single casualty. Similarly, if a hurricane causes high waves, all wind and flood damage to a taxpayer's property caused by the hurricane and the waves results from a single casualty.

(iii) Except as otherwise provided in this subdivision, the $100 limitation applies separately to each individual taxpayer who sustains a loss even though the property damaged or destroyed is owned by two or more individuals. Thus, if a house occupied by two sisters and jointly owned by them is damaged or destroyed, the $100 limitation applies separately to each sister in respect of any loss sustained by her. However, for purposes of applying the $100 limitation, a husband and wife who file a joint return for the first taxable year in which the loss is allowable as a deduction are treated as one individual taxpayer. Accordingly, if property jointly owned by a husband and wife, or property separately owned by the husband or by the wife, is damaged or destroyed by a single casualty in 1964, and a loss is sustained in that year by either or both the husband or wife, only one $100 limitation applies if a joint return is filed for 1964. If, however, the husband and wife file separate returns for 1964, the $100 limitation applies separately in respect of any loss sustained by the husband and in respect of any loss sustained by the wife. Where losses from a single casualty are sustained in two or more separate tax years, the husband and wife shall, for purposes of applying the $100 limitation to such losses, be treated as one individual for all such years if they file a joint return for the first year in which a loss is sustained from the casualty; they shall be treated as separate individuals for all such years if they file separate returns for the first such year. If a joint return is filed in the first loss year but separate returns are filed in a subsequent year, any unused portion of the $100 limitation shall be allocated equally between the husband and wife in the latter year.

(iv) If a loss is sustained in respect of property used partially for business and partially for nonbusiness purposes, the $100 limitation applies only to that portion of the loss properly attributable to the nonbusiness use. For example, if a taxpayer sustains a $1,000 loss in respect of an automobile which he uses 60 percent for business and 40 percent for nonbusiness, the loss is allocated 60 percent to business use and 40 percent to nonbusiness use. The $100 limitation applies to the portion of the loss allocable to the nonbusiness loss.

(c) *Loss sustained by an estate.* A casualty loss of property not connected with a trade or business and not incurred in any transaction entered into for profit which is sustained during the settlement of an estate shall be allowed as a deduction under sections 165(a) and 641(b) in computing the taxable income of the estate if the loss has not been allowed under section 2054 in computing the taxable estate of the decedent and if the statement has been filed in accordance with § 1.642(g)-1. See section 165(c)(3).

(d) *Loss treated as though attributable to a trade or business.* For the rule treating a casualty loss not connected with a trade or business as though it were a deduction attributable to a trade or business for purposes of computing a net operating loss, see paragraph (a)(3)(iii) of § 1.172-3.

(e) *Effective date.* The rules of this section are applicable to any taxable year beginning after January 16, 1960. If, for any taxable year beginning on or before such date, a taxpayer computed the amount of any casualty loss in accordance with the rules then applicable, such taxpayer is not required to change the amount of the casualty loss allowable for any such prior taxable year. On the other hand, the taxpayer may, if he so desires, amend his income tax return for such year to compute the amount of a casualty loss in accordance with the provisions of this section, but no provision in this section shall be construed as extending the period of limitations within which a claim for credit or refund may be filed under section 6511.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3652, Mar. 24, 1964; T.D. 6786, 29 FR 18501, Dec. 29, 1964; T.D. 7522, 42 FR 63411, Dec. 16, 1977]

§ 1.165–8 Theft losses.

(a) *Allowance of deduction.* (1) Except as otherwise provided in paragraphs (b) and (c) of this section, any loss arising from theft is allowable as a deduction under section 165(a) for the taxable year in which the loss is sustained. See section 165(c)(3).

(2) A loss arising from theft shall be treated under section 165(a) as sustained during the taxable year in which the taxpayer discovers the loss. See section 165(e). Thus, a theft loss is not deductible under section 165(a) for the taxable year in which the theft actually occurs unless that is also the year in which the taxpayer discovers the loss. However, if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, see paragraph (d) of § 1.165–1.

(3) The same theft loss shall not be taken into account both in computing a tax under chapter 1, relating to the income tax, or chapter 2, relating to additional income taxes, of the Internal Revenue Code of 1939 and in computing the income tax under the Internal Revenue Code of 1954. See section 7852(c), relating to items not to be twice deducted from income.

(b) *Loss sustained by an estate.* A theft loss of property not connected with a trade or business and not incurred in any transaction entered into for profit which is discovered during the settlement of an estate, even though the theft actually occurred during a taxable year of the decedent, shall be allowed as a deduction under sections 165(a) and 641(b) in computing the taxable income of the estate if the loss has not been allowed under section 2054 in computing the taxable estate of the decedent and if the statement has been filed in accordance with § 1.642(g)–1. See section 165(c)(3). For purposes of determining the year of deduction, see paragraph (a)(2) of this section.

(c) *Amount deductible.* The amount deductible under this section in respect of a theft loss shall be determined consistently with the manner prescribed in § 1.165–7 for determining the amount of casualty loss allowable as a deduction under section 165(a). In applying the provisions of paragraph (b) of § 1.165–7 for this purpose, the fair market value of the property immediately after the theft shall be considered to be zero. In the case of a loss sustained after December 31, 1963, in a taxable year ending after such date, in respect of property not used in a trade or business or for income producing purposes, the amount deductible shall be limited to that portion of the loss which is in excess of $100. For rules applicable in applying the $100 limitation, see paragraph (b)(4) of § 1.165–7. For other rules relating to the treatment of deductible theft losses, see § 1.1231–1, relating to the involuntary conversion of property.

(d) *Definition.* For purposes of this section the term "theft" shall be deemed to include, but shall not necessarily be limited to, larceny, embezzlement, and robbery.

(e) *Application to inventories.* This section does not apply to a theft loss reflected in the inventories of the taxpayer. For provisions relating to inventories, see section 471 and the regulations thereunder.

(f) *Example.* The application of this section may be illustrated by the following example:

Example. In 1955 B, who makes her return on the basis of the calendar year, purchases for personal use a diamond brooch costing $4,000. On November 30, 1961, at which time it has a fair market value of $3,500, the brooch is stolen; but B does not discover the loss until January 1962. The brooch was fully insured against theft. A controversy develops with the insurance company over its liability in respect of the loss. However, in 1962, B has a reasonable prospect of recovery of the fair market value of the brooch from the insurance company. The controversy is settled in March 1963, at which time B receives $2,000 in insurance proceeds to cover the loss from theft. No deduction for the loss is allowable for 1961 or 1962; but the amount of the deduction allowable under section 165(a) for the taxable year 1963 is $1,500, computed as follows:

Value of property immediately before theft	$3,500
Less: Value of property immediately after the theft	0
Balance	3,500

Loss to be taken into account for purposes of section 165(a): ($3,500 but not to exceed adjusted basis of $4,000 at time of theft)	$3,500
Less: Insurance received in 1963	2,000
Deduction allowable for 1963	1,500

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6786, 29 FR 18502, Dec. 29, 1964]

§ 1.165–9 Sale of residential property.

(a) *Losses not allowed.* A loss sustained on the sale of residential property purchased or constructed by the taxpayer for use as his personal residence and so used by him up to the time of the sale is not deductible under section 165(a).

(b) *Property converted from personal use.* (1) If property purchased or constructed by the taxpayer for use as his personal residence is, prior to its sale, rented or otherwise appropriated to income-producing purposes and is used for such purposes up to the time of its sale, a loss sustained on the sale of the property shall be allowed as a deduction under section 165(a).

(2) The loss allowed under this paragraph upon the sale of the property shall be the excess of the adjusted basis prescribed in § 1.1011–1 for determining loss over the amount realized from the sale. For this purpose, the adjusted basis for determining loss shall be the lesser of either of the following amounts, adjusted as prescribed in § 1.1011–1 for the period subsequent to the conversion of the property to income-producing purposes:

(i) The fair market value of the property at the time of conversion, or

(ii) The adjusted basis for loss, at the time of conversion, determined under § 1.1011–1 but without reference to the fair market value.

(3) For rules relating to casualty losses of property converted from personal use, see paragraph (a)(5) of § 1.165–7. To determine the basis for depreciation in the case of such property, see § 1.167(g)–1. For limitations on the loss from the sale of a capital asset, see paragraph (c)(3) of § 1.165–1.

(c) *Examples.* The application of paragraph (b) of this section may be illustrated by the following examples:

Example (1). Residential property is purchased by the taxpayer in 1943 for use as his personal residence at a cost of $25,000, of which $15,000 is allocable to the building. The taxpayer uses the property as his personal residence until January 1, 1952, at which time its fair market value is $22,000, of which $12,000 is allocable to the building. The taxpayer rents the property from January 1, 1952, until January 1, 1955, at which time it is sold for $16,000. On January 1, 1952, the building has an estimated useful life of 20 years. It is assumed that the building has no estimated salvage value and that there are no adjustments in respect of basis other than depreciation, which is computed on the straight-line method. The loss to be taken into account for purposes of section 165(a) for the taxable year 1955 is $4,200, computed as follows:

Basis of property at time of conversion for purposes of this section (that is, the lesser of $25,000 cost or $22,000 fair market value)	$22,000
Less: Depreciation allowable from January 1, 1952, to January 1, 1955 (3 years at 5 percent based on $12,000, the value of the building at time of conversion, as prescribed by § 1.167(g)–1)	1,800
Adjusted basis prescribed in § 1.1011–1 for determining loss on sale of the property	20,200
Less: Amount realized on sale	16,000
Loss to be taken into account for purposes of section 165(a)	4,200

In this example the value of the building at the time of conversion is used as the basis for computing depreciation. See example (2) of this paragraph wherein the adjusted basis of the building is required to be used for such purpose.

Example (2). Residential property is purchased by the taxpayer in 1940 for use as his personal residence at a cost of $23,000, of which $10,000 is allocable to the building. The taxpayer uses the property as his personal residence until January 1, 1953, at which time its fair market value is $20,000, of which $12,000 is allocable to the building. The taxpayer rents the property from January 1, 1953, until January 1, 1957, at which time it is sold for $17,000. On January 1, 1953, the building has an estimated useful life of 20 years. It is assumed that the building has no estimated salvage value and that there are no adjustments in respect of basis other than depreciation, which is computed on the straight-line method. The loss to be taken into account for purposes of section 165(a) for the taxable year 1957 is $1,000, computed as follows:

Basis of property at time of conversion for purposes of this section (that is, the lesser of $23,000 cost or $20,000 fair market value)	$20,000
Less: Depreciation allowable from January 1, 1953, to January 1, 1957 (4 years at 5 percent based on $10,000, the cost of the building, as prescribed by § 1.167(g)–1	2,000
Adjusted basis prescribed in § 1.1011–1 for determining loss on sale of the property	$18,000
Less: Amount realized on sale	17,000
Loss to be taken into account for purposes of section 165(a)	1,000

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3652, Mar. 24, 1964]

§ 1.165–10 Wagering losses.

Losses sustained during the taxable year on wagering transactions shall be allowed as a deduction but only to the extent of the gains during the taxable year from such transactions. In the case of a husband and wife making a joint return for the taxable year, the combined losses of the spouses from wagering transactions shall be allowed to the extent of the combined gains of the spouses from wagering transactions.

§ 1.165–11 Election in respect of losses attributable to a disaster.

(a) *In general.* Section 165(h) provides that a taxpayer who has sustained a disaster loss which is allowable as a deduction under section 165(a) may, under certain circumstances, elect to deduct such loss for the taxable year immediately preceding the taxable year in which the disaster actually occurred.

(b) *Loss subject to election.* The election provided by section 165(h) and paragraph (a) of this section applies only to a loss:

(1) Arising from a disaster resulting in a determination referred to in subparagraph (2) of this paragraph and occurring—

(i) After December 31, 1971, or

(ii) After December 31, 1961, and before January 1, 1972, and during the period following the close of a particular taxable year of the taxpayer and on or before the due date for filing the income tax return for that taxable year (determined without regard to any extension of time granted the taxpayer for filing such return);

(2) Occurring in an area subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief Act of 1974; and

(3) Constituting a loss otherwise allowable as a deduction for the year in which the loss occurred under section 165(a) and the provisions of §§ 1.165–1 through 1.165–10 which are applicable to such losses.

(c) *Amount of loss to which election applies.* The amount of the loss to which section 165(h) and this section apply shall be the amount of the loss sustained during the period specified in paragraph (b)(1) of this section computed in accordance with the provisions of section 165 and those provisions of §§ 1.165–1 through 1.165–10 which are applicable to such losses. However, for purposes of making such computation, the period specified in paragraph (b)(1) of this section shall be deemed to be a taxable year.

(d) *Scope and effect of election.* An election made pursuant to section 165(h) and this section in respect of a loss arising from a particular disaster shall apply to the entire loss sustained by the taxpayer from such disaster during the period specified in paragraph (b)(1) of this section in the area specified in paragraph (b)(2) of this section. If such an election is made, the disaster to which the election relates will be deemed to have occurred in the taxable year immediately preceding the taxable year in which the disaster actually occurred, and the loss to which the election applies will be deemed to have been sustained in such preceding taxable year.

(e) *Time and manner of making election.* An election to claim a deduction with respect to a disaster loss described in paragraph (b) of this section for the taxable year immediately preceding the taxable year in which the disaster actually occurred must be made by filing a return, an amended return, or a claim for refund clearly showing that the election provided by section 165(h) has been made. In general, the return or claim should specify the date or dates of the disaster which gave rise to the loss, and the

city, town, county, and State in which the property which was damaged or destroyed was located at the time of the disaster. An election in respect of a loss arising from a particular disaster occurring after December 31, 1971, must be made on or before the later of (1) the due date for filing the income tax return (determined without regard to any extension of time granted the taxpayer for filing such return) for the taxable year in which the disaster actually occurred, or (2) the due date of filing the income tax return (determined with regard to any extension of time granted the taxpayer for filing such return) for the taxable year immediately preceding the taxable year in which the disaster actually occurred. Such election shall be irrevocable after the later of (1) 90 days after the date on which the election was made, or (2) March 6, 1973. No revocation of such election shall be effective unless the amount of any credit or refund which resulted from such election is paid to the Internal Revenue Service within the revocation period described in the preceding sentence. However, in the case of a revocation made before receipt by the taxpayer of a refund claimed pursuant to such election, the revocation shall be effective if the refund is repaid within 30 calendar days after such receipt. An election in respect of a loss arising from a particular disaster occurring after December 31, 1961, and before January 1, 1972, must be made on or before the later of (1) the 15th day of the third month following the month in which falls the date prescribed for the filing of the income tax return (determined without regard to any extension of time granted the taxpayer for filing such return) for the taxable year immediately preceding the taxable year in which the disaster actually occurred, or (2) the due date for filing the income tax return (determined with regard to any extension of time granted the taxpayer for filing such return) for the taxable year immediately preceding the taxable year in which the disaster actually occurred. Such election shall be irrevocable after the date by which it must be made.

[T.D. 6735, 29 FR 6493, May 19, 1964, as amended by T.D. 7224, 37 FR 25928, Dec. 6, 1972; T.D. 7522, 42 FR 63411, Dec. 16, 1977]

§ 1.166–1 Bad debts.

(a) *Allowance of deduction.* Section 166 provides that, in computing taxable income under section 63, a deduction shall be allowed in respect of bad debts owed to the taxpayer. For this purpose, bad debts shall, subject to the provisions of section 166 and the regulations thereunder, be taken into account either as—

(1) A deduction in respect of debts which become worthless in whole or in part; or as

(2) A deduction for a reasonable addition to a reserve for bad debts.

(b) *Manner of selecting method.* (1) A taxpayer filing a return of income for the first taxable year for which he is entitled to a bad debt deduction may select either of the two methods prescribed by paragraph (a) of this section for treating bad debts, but such selection is subject to the approval of the district director upon examination of the return. If the method so selected is approved, it shall be used in returns for all subsequent taxable years unless the Commissioner grants permission to use the other method. A statement of facts substantiating any deduction claimed under section 166 on account of bad debts shall accompany each return of income.

(2) Taxpayers who have properly selected one of the two methods for treating bad debts under provisions of prior law corresponding to section 166 shall continue to use that method for all subsequent taxable years unless the Commissioner grants permission to use the other method.

(3)(i) For taxable years beginning after December 31, 1959, application for permission to change the method of treating bad debts shall be made in accordance with section 446(e) and paragraph (e)(3) of § 1.446–1.

(ii) For taxable years beginning before January 1, 1960, application for permission to change the method of treating bad debts shall be made at least 30 days before the close of the taxable year for which the change is effective.

(c) *Bona fide debt required.* Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A gift or contribution to capital shall not be considered a debt for purposes of section 166. The fact that a bad debt is not due at the time of deduction shall not of itself prevent its allowance under section 166. For the disallowance of deductions for bad debts owed by a political party, see § 1.271-1.

(d) *Amount deductible*—(1) *General rule.* Except in the case of a deduction for a reasonable addition to a reserve for bad debts, the basis for determining the amount of deduction under section 166 in respect of a bad debt shall be the same as the adjusted basis prescribed by § 1.1011-1 for determining the loss from the sale or other disposition of property. To determine the allowable deduction in the case of obligations acquired before March 1, 1913, see also paragraph (b) of § 1.1053-1.

(2) *Specific cases.* Subject to any provision of section 166 and the regulations thereunder which provides to the contrary, the following amounts are deductible as bad debts:

(i) *Notes or accounts receivable.* (*a*) If, in computing taxable income, a taxpayer values his notes or accounts receivable at their fair market value when received, the amount deductible as a bad debt under section 166 in respect of such receivables shall be limited to such fair market value even though it is less than their face value.

(*b*) A purchaser of accounts receivable which become worthless during the taxable year shall be entitled under section 166 to a deduction which is based upon the price he paid for such receivables but not upon their face value.

(ii) *Bankruptcy claim.* Only the difference between the amount received in distribution of the assets of a bankrupt and the amount of the claim may be deducted under section 166 as a bad debt.

(iii) *Claim against decedent's estate.* The excess of the amount of the claim over the amount received by a creditor of a decedent in distribution of the assets of the decedent's estate may be considered a worthless debt under section 166.

(e) *Prior inclusion in income required.* Worthless debts arising from unpaid wages, salaries, fees, rents, and similar items of taxable income shall not be allowed as a deduction under section 166 unless the income such items represent has been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year.

(f) *Recovery of bad debts.* Any amount attributable to the recovery during the taxable year of a bad debt, or of a part of a bad debt, which was allowed as a deduction from gross income in a prior taxable year shall be included in gross income for the taxable year of recovery, except to the extent that the recovery is excluded from gross income under the provisions of § 1.111-1, relating to the recovery of certain items previously deducted or credited. This paragraph shall not apply, however, to a bad debt which was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts.

(g) *Worthless securities.* (1) Section 166 and the regulations thereunder do not apply to a debt which is evidenced by a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. See section 166(e). For provisions allowing the deduction of a loss resulting from the worthlessness of such a debt, see § 1.165-5.

(2) The provisions of subparagraph (1) of this paragraph do not apply to any loss sustained by a bank and resulting from the worthlessness of a security described in section 165(g)(2)(C). See paragraph (a) of § 1.582-1.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6996, 34 FR 835, Jan. 18, 1969]

§ 1.166-2 Evidence of worthlessness.

(a) *General rule.* In determining whether a debt is worthless in whole or in part the district director will consider all pertinent evidence, including

the value of the collateral, if any, securing the debt and the financial condition of the debtor.

(b) *Legal action not required.* Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for purposes of the deduction under section 166.

(c) *Bankruptcy*—(1) *General rule.* Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt.

(2) *Year of deduction.* In bankruptcy cases a debt may become worthless before settlement in some instances; and in others, only when a settlement in bankruptcy has been reached. In either case, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, thereby confirming the conclusion that the debt is worthless, shall not authorize the shifting of the deduction under section 166 to such later year.

(d) *Banks and other regulated corporations*—(1) *Worthlessness presumed in year of charge-off.* If a bank or other corporation which is subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards, charges off a debt in whole or in part, either—

(i) In obedience to the specific orders of such authorities, or

(ii) In accordance with established policies of such authorities, and, upon their first audit of the bank or other corporation subsequent to the charge-off, such authorities confirm in writing that the charge-off would have been subject to such specific orders if the audit had been made on the date of the charge-off,

then the debt shall, to the extent charged off during the taxable year, be conclusively presumed to have become worthless, or worthless only in part, as the case may be, during such taxable year. But no such debt shall be so conclusively presumed to be worthless, or worthless only in part, as the case may be, if the amount so charged off is not claimed as a deduction by the taxpayer at the time of filing the return for the taxable year in which the charge-off takes place.

(2) *Evidence of worthlessness in later taxable year.* If such a bank or other corporation does not claim a deduction for such a totally or partially worthless debt in its return for the taxable year in which the charge-off takes place, but claims the deduction for a later taxable year, then the charge-off in the prior taxable year shall be deemed to have been involuntary and the deduction under section 166 shall be allowed for the taxable year for which claimed, provided that the taxpayer produces sufficient evidence to show that—

(i) The debt became wholly worthless in the later taxable year, or became recoverable only in part subsequent to the taxable year of the involuntary charge-off, as the case may be; and,

(ii) To the extent that the deduction claimed in the later taxable year for a debt partially worthless was not involuntarily charged off in prior taxable years, it was charged off in the later taxable year.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7254, 38 FR 2418, Jan. 26, 1973]

§ 1.166-3 Partial or total worthlessness.

(a) *Partial worthlessness*—(1) *Applicable to specific debts only.* A deduction under section 166(a)(2) on account of partially worthless debts shall be allowed with respect to specific debts only.

(2) *Charge-off required.* (i) If, from all the surrounding and attending circumstances, the district director is satisfied that a debt is partially worthless, the amount which has become worthless shall be allowed as a deduction under section 166(a)(2) but only to the extent charged off during the taxable year.

(ii) If a taxpayer claims a deduction for a part of a debt for the taxable year within which that part of the debt is charged off and the deduction is disallowed for that taxable year, then, in a case where the debt becomes partially worthless after the

close of that taxable year, a deduction under section 166(a)(2) shall be allowed for a subsequent taxable year but not in excess of the amount charged off in the prior taxable year plus any amount charged off in the subsequent taxable year. In such instance, the charge-off in the prior taxable year shall, if consistently maintained as such, be sufficient to that extent to meet the charge-off requirement of section 166(a)(2) with respect to the subsequent taxable year.

(iii) Before a taxpayer may deduct a debt in part, he must be able to demonstrate to the satisfaction of the district director the amount thereof which is worthless and the part thereof which has been charged off.

(b) *Total worthlessness.* If a debt becomes wholly worthless during the taxable year, the amount thereof which has not been allowed as a deduction from gross income for any prior taxable year shall be allowed as a deduction for the current taxable year.

§ 1.166-4 Reserve for bad debts.

(a) *Allowance of deduction.* A taxpayer who has established the reserve method of treating bad debts and has maintained proper reserve accounts for bad debts or who, in accordance with paragraph (b) of § 1.166-1, adopts the reserve method of treating bad debts may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items.

(b) *Reasonableness of addition to reserve*—(1) *Relevant factors.* What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.

(2) *Correction of errors in prior estimates.* In the event that subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of the reasonable addition necessary in the current taxable year.

(c) *Statement required.* A taxpayer using the reserve method shall file with his return a statement showing—

(1) The volume of his charge sales or other business transactions for the taxable year and the percentage of the reserve to such amount;

(2) The total amount of notes and accounts receivable at the beginning and close of the taxable year;

(3) The amount of the debts which have become wholly or partially worthless and have been charged against the reserve account; and

(4) The computation of the addition to the reserve for bad debts.

(d) *Special rules applicable to financial institutions.* (1) For special rules for the addition to the bad debt reserves of certain banks, see §§ 1.585-1 through 1.585-3.

(2) For special rules for the addition to the bad debt reserves of small business investment companies and business development corporations, see §§ 1.586-1 and 1.586-2.

(3) For special rules for the addition to the bad debts reserves of certain mutual savings banks, domestic building and loan associations, and cooperative banks, see §§ 1.593-1 through 1.593-11.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6728, 29 FR 5855, May 5, 1964; T.D. 7444, 41 FR 53481, Dec. 7, 1976]

§ 1.166-5 Nonbusiness debts.

(a) *Allowance of deduction as capital loss.* (1) The loss resulting from any nonbusiness debt's becoming partially or wholly worthless within the taxable year shall not be allowed as a deduction under either section 166(a) or section 166(c) in determining the taxable income of a taxpayer other than a corporation. See section 166(d)(1)(A).

(2) If, in the case of a taxpayer other than a corporation, a nonbusiness debt becomes wholly worthless within the taxable year, the loss resulting therefrom shall be treated as a loss from

the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). Such a loss is subject to the limitations provided in section 1211, relating to the limitation on capital losses, and section 1212, relating to the capital loss carryover, and in the regulations under those sections. A loss on a nonbusiness debt shall be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a nonbusiness debt which is recoverable in part during the taxable year.

(b) *Nonbusiness debt defined.* For purposes of section 166 and this section, a nonbusiness debt is any debt other than—

(1) A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or

(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph. For purposes of section 166 and this section, a nonbusiness debt does not include a debt described in section 165(g)(2)(C). See § 1.165-5, relating to losses on worthless securities.

(c) *Guaranty of obligations.* For provisions treating a loss sustained by a guarantor of obligations as a loss resulting from the worthlessness of a debt, see §§ 1.166-8 and 1.166-9.

(d) *Examples.* The application of this section may be illustrated by the following examples involving a case where A, an individual who is engaged in the grocery business and who makes his return on the basis of the calendar year, extends credit to B in 1955 on an open account:

Example (1). In 1956 A sells the business but retains the claim against B. The claim becomes worthless in A's hands in 1957. A's loss is not controlled by the nonbusiness debt provisions, since the original consideration has been advanced by A in his trade or business.

Example (2). In 1956 A sells the business to C but sells the claim against B to the taxpayer, D. The claim becomes worthless in D's hands in 1957. During 1956 and 1957, D is not engaged in any trade or business. D's loss is controlled by the nonbusiness debt provisions even though the original consideration has been advanced by A in his trade or business, since the debt has not been created or acquired in connection with a trade or business of D and since in 1957 D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such claim is a proximate result.

Example (3). In 1956 A dies, leaving the business, including the accounts receivable, to his son, C, the taxpayer. The claim against B becomes worthless in C's hands in 1957. C's loss is not controlled by the nonbusiness debt provisions. While C does not advance any consideration for the claim, or create or acquire it in connection with his trade or business, the loss is sustained as a proximate incident to the conduct of the trade or business in which he is engaged at the time the debt becomes worthless.

Example (4). In 1956 A dies, leaving the business to his son, C, but leaving the claim against B to his son, D, the taxpayer. The claim against B becomes worthless in D's hands in 1957. During 1956 and 1957, D is not engaged in any trade or business. D's loss is controlled by the nonbusiness debt provisions even though the original consideration has been advanced by A in his trade or business, since the debt has not been created or acquired in connection with a trade or business of D and since in 1957 D is not engaged in a trade or business incident to

the conduct of which a loss from the worthlessness of such claim is a proximate result.

Example (5). In 1956 A dies; and, while his executor, C, is carrying on the business, the claim against B becomes worthless in 1957. The loss sustained by A's estate is not controlled by the nonbusiness debt provisions. While C does not advance any consideration for the claim on behalf of the estate, or create or acquire it in connection with a trade or business in which the estate is engaged, the loss is sustained as a proximate incident to the conduct of the trade or business in which the estate is engaged at the time the debt becomes worthless.

Example (6). In 1956, A, in liquidating the business, attempts to collect the claim against B but finds that it has become worthless. A's loss is not controlled by the nonbusiness debt provisions, since the original consideration has been advanced by A in his trade or business and since a loss incurred in liquidating a trade or business is a proximate incident to the conduct thereof.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7657, 44 FR 68464, Nov. 29, 1979; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.166-6 Sale of mortgaged or pledged property.

(a) *Deficiency deductible as bad debt*—(1) *Principal amount.* If mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt, and the portion of the indebtedness remaining unsatisfied after the sale is wholly or partially uncollectible, the mortgagee or pledgee may deduct such amount under section 166(a) (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it becomes wholly worthless or is charged off as partially worthless. See § 1.166-3.

(2) *Accrued interest.* Accrued interest may be included as part of the deduction allowable under this paragraph, but only if it has previously been returned as income.

(b) *Realization of gain or loss*—(1) *Determination of amount.* If, in the case of a sale described in paragraph (a) of this section, the creditor buys in the mortgaged or pledged property, loss or gain is also realized, measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by the creditor) and the fair market value of the property.

(2) *Fair market value defined.* The fair market value of the property for this purpose shall, in the absence of clear and convincing proof to the contrary, be presumed to be the amount for which it is bid in by the taxpayer.

(c) *Basis of property purchased.* If the creditor subsequently sells the property so acquired, the basis for determining gain or loss upon the subsequent sale is the fair market value of the property at the date of its acquisition by the creditor.

(d) *Special rules applicable to certain banking organizations.* For special rules relating to the treatment of mortgaged or pledged property by certain mutual savings banks, domestic building and loan associations, and cooperative banks, see section 595 and the regulations thereunder.

(e) *Special rules applicable to certain reacquisitions of real property.* Notwithstanding this section, special rules apply for taxable years beginning after September 2, 1964 (and for certain taxable years beginning after December 31, 1957), to the gain or loss on certain reacquisitions of real property, to indebtedness remaining unsatisfied as a result of such reacquisitions, and to the basis of the reacquired real property. See §§ 1.1038-1 through 1.1038-3.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6814, 30 FR 4472, Apr. 7, 1965, T.D. 6916, 32 FR 5923, Apr. 13, 1967]

§ 1.166-7 Worthless bonds issued by an individual.

(a) *Allowance of deduction.* A bond or other similar obligation issued by an individual, if it becomes worthless in whole or in part, is subject to the bad debt provisions of section 166. The loss from the worthlessness of any such bond or obligation is deductible in accordance with section 166(a), unless such bond or obligation is a nonbusiness debt as defined in section 166(d)(2). If the bond or obligation is a

nonbusiness debt, it is subject to section 166(d) and § 1.166–5.

(b) *Decline in market value.* A taxpayer possessing debts evidenced by bonds or other similar obligations issued by an individual shall not be allowed any deduction under section 166 on account of mere market fluctuation in the value of such obligations.

(c) *Worthless bonds issued by corporation.* For provisions allowing the deduction under section 165(a) of the loss sustained upon the worthlessness of any bond or similar obligation issued by a corporation or a government, see § 1.165–5.

(d) *Application to inventories.* This section does not apply to any loss upon the worthlessness of any bond or similar obligation reflected in inventories required to be taken by a dealer in securities under section 471. See § 1.471–5.

§ 1.166–8 Losses of guarantors, endorsers, and indemnitors incurred on agreements made before January 1, 1976.

(a) *Noncorporate obligations*—(1) *Deductible as bad debt.* A payment during the taxable year by a taxpayer other than a corporation in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of an obligation issued by a person other than a corporation shall, for purposes of section 166 and the regulations thereunder, be treated as a debt's becoming worthless within the taxable year, if—

(i) The proceeds of the obligation so issued have been used in the trade or business of the borrower, and

(ii) The borrower's obligation to the person to whom the taxpayer's payment is made is worthless at the time of payment except for the existence of the guaranty, endorsement, or indemnity, whether or not such obligation has in fact become worthless within the taxable year in which payment is made.

(2) *Nonbusiness debt rule not applicable.* If a payment is treated as a loss in accordance with the provisions of subparagraph (1) of this paragraph, section 166(d), relating to the special rule for losses sustained on the worthlessness of a nonbusiness debt, shall not apply. Accordingly, in each instance the loss shall be deducted under section 166(a)(1) as a wholly worthless debt even though there has been a discharge of only a part of the taxpayer's obligation. Thus, if the taxpayer makes a payment during the taxable year in discharge of only part of his obligation as a guarantor, endorser, or indemnitor, he may treat such payment under section 166(a)(1) as a debt's becoming wholly worthless within the taxable year, provided that he can establish that such part of the borrower's obligation to the person to whom the taxpayer's payment is made is worthless at the time of payment and the conditions of subparagraph (1) of this paragraph have otherwise been satisfied.

(3) *Other applicable provisions.* Other provisions of the internal revenue laws relating to bad debts, such as section 111, relating to the recovery of bad debts, shall be deemed to apply to any payment which, under the provisions of this paragraph, is treated as a bad debt. If the requirements of section 166(f) are not met, any loss sustained by a guarantor, endorser, or indemnitor upon the worthlessness of the debtor's obligation shall be treated under the provisions of law applicable thereto. See, for example, paragraph (b) of this section.

(b) *Corporate obligations.* The loss sustained during the taxable year by a taxpayer other than a corporation in discharge of all of his obligation as a guarantor of an obligation issued by a corporation shall be treated, in accordance with section 166(d) and the regulations thereunder, as a loss sustained on the worthlessness of a nonbusiness debt if the debt created in the guarantor's favor as a result of the payment does not come within the exceptions prescribed by section 166(d)(2) (A) or (B). See paragraph (a)(2) of § 1.166–5.

(c) *Examples.* The application of this section may be illustrated by the following examples:

Example (1). During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of B, an individual, to the X Bank, the proceeds of the obligation being used in B's business. B defaults on his obligation in 1956. A makes payment to the X Bank during 1957 in discharge of his entire obliga-

tion as a guarantor, the obligation of B to the X Bank being wholly worthless. For his taxable year 1957, A is entitled to a deduction under section 166(a)(1) as a result of his payment during that year.

Example (2). During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of B, an individual, to the X Bank, the proceeds of the obligation being used in B's business. In 1956, B pays a part of his obligation to the X Bank but defaults on the remaining part. In 1957, A makes payment to the X Bank, in discharge of part of his obligation as a guarantor, of the remaining unpaid part of B's obligation to the bank, such part of B's obligation then being worthless. For his taxable year 1957, A is entitled to a deduction under section 166(a)(1) as a result of his payment of the remaining unpaid part of B's obligation.

Example (3). During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of B, an individual, to the X Bank, the proceeds of the obligation being used for B's personal use. B defaults on his obligation in 1956. A makes payment to the X Bank during 1957 in discharge of his entire obligation as a guarantor, the obligation of B to X Bank being wholly worthless. A may not apply the benefit of section 166(f) to his loss, since the proceeds of B's obligation have not been used in B's trade or business.

Example (4). During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of Y Corporation to the X Bank, the proceeds of the obligation being used in Y Corporation's business. Y Corporation defaults on its obligation in 1956. A makes payment to the X Bank during 1957 in discharge of his entire obligation as a guarantor, the obligation of Y Corporation to the X Bank being wholly worthless. At no time during 1955 or 1957 is A engaged in a trade or business. For his taxable year 1957, A is entitled to deduct a capital loss in accordance with the provisions of section 166(d) and paragraph (a)(2) of § 1.166–5. He may not apply the benefit of section 166(f) to his loss, since his payment is in discharge of an obligation issued by a corporation.

(d) *Effective date.* This section applies only to losses, regardless of the taxable year in which incurred, on agreements made before January 1, 1976.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7657, 44 FR 68464, Nov. 29, 1979]

§ 1.166–9 Losses of guarantors, endorsers, and indemnitors incurred, on agreements made after December 31, 1975, in taxable years beginning after such date.

(a) *Payment treated as worthless business debt.* This paragraph applies to taxpayers who, after December 31, 1975, enter into an agreement in the course of their trade or business to act as (or in a manner essentially equivalent to) a guarantor, endorser, or indemnitor of (or other secondary obligor upon) a debt obligation. Subject to the provisions of paragraphs (c), (d), and (e) of this section, a payment of principal or interest made during a taxable year beginning after December 31, 1975, by the taxpayer in discharge of part or all of the taxpayer's obligation as a guarantor, endorser, or idemnitor is treated as a business debt becoming worthless in the taxable year in which the payment is made or in the taxable year described in paragraph (e)(2) of this section. Neither section 163 (relating to interest) nor section 165 (relating to losses) shall apply with respect to such a payment.

(b) *Payment treated as worthless nonbusiness debt.* This paragraph applies to taxpayers (other than corporations) who, after December 31, 1975, enter into a transaction for profit, but not in the course of their trade or business, to act as (or in a manner essentially equivalent to) a guarantor, endorser, or indemnitor of (or other secondary obligor upon) a debt obligation. Subject to the provisions of paragraphs (c), (d), and (e) of this section, a payment of principal or interest made during a taxable year beginning after December 31, 1975, by the taxpayer in discharge of part or all of the taxpayer's obligation as a guarantor, endorser, or indemnitor is treated as a worthless nonbusiness debt in the taxable year in which the payment is made or in the taxable year described in paragraph (e)(2) of this section. Neither section 163 nor section 165 shall apply with respect to such a payment.

(c) *Obligations issued by corporations.* No treatment as a worthless debt is allowed with respect to a payment made by the taxpayer in dis-

charge of part or all of the taxpayer's obligation as guarantor, endorser, or indemnitor of an obligation issued by a corporation if—

(1) The taxpayer is considered the primary obligor (see § 1.385-9), or

(2) The payment constitutes a contribution to capital by a shareholder.

The rules of this paragraph (c) apply to payments whenever made (see paragraph (f) of this section).

(d) *Certain payments treated as worthless debts.* A payment in discharge of part or all of taxpayer's agreement to act as guarantor, endorser, or indemnitor of an obligation is to be treated as a worthless debt only if—

(1) The agreement was entered into in the course of the taxpayer's trade or business or a transaction for profit;

(2) There was an enforceable legal duty upon the taxpayer to make the payment (except that legal action need not have been brought against the taxpayer); and

(3) The agreement was entered into before the obligation became worthless (or partially worthless in the case of an agreement entered into in the course of the taxpayer's trade or business). See §§ 1.166-2 and 1.166-3 for rules on worthless and partially worthless debts. For purposes of this paragraph (d)(3), an agreement is considered as entered into before the obligation became worthless (or partially worthless) if there was a reasonable expectation on the part of the taxpayer at the time the agreement was entered into that the taxpayer would not be called upon to pay the debt (subject to such agreement) without full reimbursement from the issuer of the obligation.

(e) *Special rules*—(1) *Reasonable consideration required.* Treatment as a worthless debt of a payment made by a taxpayer in discharge of part or all of the taxpayer's agreement to act as a guarantor, endorser, or indemnitor of an obligation is allowed only if the taxpayer demonstrates that reasonable consideration was received for entering into the agreement. For purposes of this paragraph (e)(1), reasonable consideration is not limited to direct consideration in the form of cash or property. Thus, where a taxpayer can demonstrate that the agreement was given without direct consideration in the form of cash or property but in accordance with normal business practice or for a good faith business purpose, worthless debt treatment is allowed with respect to a payment in discharge of part or all of the agreement if the conditions of this section are met. However, consideration received from a taxpayer's spouse or any individual listed in section 152(a) must be direct consideration in the form of cash or property.

(2) *Right of subrogation.* With respect to a payment made by a taxpayer in discharge of part or all of the taxpayer's agreement to act as a guarantor, endorser, or indemnitor where the agreement provides for a right of subrogation or other similar right against the issuer, treatment as a worthless debt is not allowed until the taxable year in which the right of subrogation or other similar right becomes totally worthless (or partially worthless in the case of an agreement which arose in the course of the taxpayer's trade or business).

(3) *Other applicable provisions.* Unless inconsistent with this section, other Internal Revenue laws concerning worthless debts, such as section 111 relating to the recovery of bad debts, apply to any payment which, under the provisions of this section, is treated as giving rise to a worthless debt.

(4) *Taxpayer defined.* For purposes of this section, except as otherwise provided, the term "taxpayer" means any taxpayer and includes individuals, corporations, partnerships, trusts and estates.

(f) *Effective date.* This section applies to losses incurred on agreements made after December 31, 1975, in taxable years beginning after such date. However, paragraph (c) of this section also applies to payments, regardless of the taxable year in which made, under agreements made before January 1, 1976.

[T.D. 7657, 44 FR 68465, Nov. 29, 1979, as amended by T.D. 7747, 45 FR 86445, Dec. 31, 1980]

EFFECTIVE DATE NOTE: At 45 FR 86445, Dec. 31, 1980, § 1.166-9(c) was revised, effective Apr. 30, 1981. For the convenience of the user, the superseded text is set forth below.

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§ 1.166-9 Losses of guarantors, endorsers, and indemnitors incurred, on agreements made after December 31, 1975, in taxable years beginning after such date.

* * * * *

(c) *Obligations issued by corporations.* No treatment as a worthless debt is allowed with respect to a payment made by the taxpayer in discharge of part or all of the taxpayer's obligation as a guarantor, endorser, or indemnitor of an obligation issued by a corporation if, on the basis of the facts and circumstances at the time the obligation was entered into, the payment constitutes a contribution to capital by a shareholder. The rule of this paragraph (c) applies to payments whenever made (see paragraph (f) of this section).

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§ 1.167(a)-1 Depreciation in general.

(a) *Reasonable allowance.* Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(g) and § 1.167(g)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. However, see section 167 (f) and § 1.167(f)-1 for rules which permit a reduction in the amount of salvage value to be taken into account for certain personal property acquired after October 16, 1962. See also paragraph (c) of this section for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value. See section 179 and § 1.179-1 for a further description of the term "reasonable allowance."

(b) *Useful life.* For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)-1. If a taxpayer claims an investment credit with respect to an asset for a taxable year preceding the taxable year in which the asset is considered as placed in service under § 1.167(a)-10(b) or § 1.167(a)-11(e), the useful life of the asset under this paragraph shall be the same useful life assigned to the asset under § 1.46-3(e).

(c) *Salvage.* (1) Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from serv-

ice by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b) of this section, salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, paragraph (a) of § 1.167(b)-2 for the treatment of salvage under the declining balance method, and § 1.179-1 for the treatment of salvage in computing the additional first-year depreciation allowance. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value, see §§ 1.167(b)-1, 1.167(b)-2, and 1.167(b)-3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

(2) For taxable years beginning after December 31, 1961, and ending after October 16, 1962, see section 167(f) and § 1.167(f)-1 for rules applicable to the reduction of salvage value taken into account for certain personal property acquired after October 16, 1962.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3653, Mar. 24, 1964; T.D. 7203, 37 FR 17133, Aug. 25, 1972]

§ 1.167(a)-2 Tangible property.

The depreciation allowance in the case of tangible property applies only to that part of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. The allowance does not apply to inventories or stock in trade, or to land apart from the improvements or physical development added to it. The allowance does not apply to natural resources which are subject to the allowance for depletion provided in section 611. No deduction for depreciation shall be allowed on automobiles or other vehicles used solely for pleasure, on a building used by the taxpayer solely as his residence, or on furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business, may be depreciated.

§ 1.167(a)-3 Intangibles.

If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill. For rules with respect to organizational expenditures, see section 248 and the regulations thereunder. For rules with respect to trademark and trade name expenditures, see section 177 and the regulations thereunder.

§ 1.167(a)-4 Leased property.

Capital expenditures made by a lessee for the erection of buildings or the construction of other permanent improvements on leased property are recoverable through allowances for depreciation or amortization. If the useful life of such improvements in the hands of the taxpayer is equal to or shorter than the remaining period of the lease, the allowances shall take the form of depreciation under section 167. See §§ 1.167(b)-0, 1.167(b)-1, 1.167(b)-2, 1.167(b)-3, and 1.167(b)-4 for methods of computing such depreciation allowances. If, on the other hand, the estimated useful life of such property in the hands of the taxpayer, determined without regard to the terms of the lease, would be longer than the remaining period of such lease, the allowances shall take the form of annual deductions from gross income in an amount equal to the unrecovered cost of such capital expenditures divided by the number of years remaining of the term of the lease. Such deductions shall be in lieu of allowances for depreciation. See section 162 and the regulations thereunder. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in determining whether the useful life of the improvement exceeds the remaining term of the lease where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such date and at all times thereafter, the lessee was under a binding legal obligation to make. Capital expenditures made by a lessor for the erection of buildings or other improvements shall, if subject to depreciation allowances, be recovered by him over the estimated life of the improvements without regard to the period of the lease.

[T.D. 6520, 25 FR 13692, Dec. 24, 1960]

§ 1.167(a)-5 Apportionment of basis.

In the case of the acquisition on or after March 1, 1913, of a combination of depreciable and nondepreciable property for a lump sum, as for example, buildings and land, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time. In the case of property which is subject to both the allowance for depreciation and amortization, depreciation is allowable only with respect to the portion of the depreciable property which is not subject to the allowance for amortization and may be taken concurrently with the allowance for amortization. After the close of the amortization period or after amortization deductions have been discontinued with respect to any such property, the unrecovered cost or other basis of the depreciable portion of such property will be subject to depreciation. For adjustments to basis, see section 1016 and other applicable provisions of law.

§ 1.167(a)-6 Depreciation in special cases.

(a) *Depreciation of patents or copyrights.* The cost or other basis of a patent or copyright shall be depreciated over its remaining useful life. Its cost to the patentee includes the various Government fees, cost of drawings, models, attorneys' fees, and similar expenditures. For rules applicable to research and experimental expenditures, see sections 174 and 1016 and the regulations thereunder. If a patent or copyright becomes valueless in any year before its expiration the unrecovered cost or other basis may be deducted in that year.

(b) *Depreciation in case of farmers.* A reasonable allowance for depreciation may be claimed on farm buildings (except a dwelling occupied by the owner), farm machinery, and other physical property but not including land. Livestock acquired for work, breeding, or dairy purposes may be depreciated unless included in an inventory used to determine profits in accordance with section 61 and the regulations thereunder. Such depreciation should be determined with reference to the cost or other basis, salvage value, and the estimated useful life of the livestock. See also section 162 and the regulations thereunder relating to trade or business expenses, section 165 and the regulations thereunder relating to losses of farmers, and section

175 and the regulations thereunder relating to soil or water conservation expenditures.

§ 1.167(a)-7 Accounting for depreciable property.

(a) Depreciable property may be accounted for by treating each individual item as an account, or by combining two or more assets in a single account. Assets may be grouped in an account in a variety of ways. For example, assets similar in kind with approximately the same useful lives may be grouped together. Such an account is commonly known as a group account. Another appropriate grouping might consist of assets segregated according to use without regard to useful life, for example, machinery and equipment, furniture and fixtures, or transportation equipment. Such an account is commonly known as a classified account. A broader grouping, where assets are included in the same account regardless of their character or useful lives, is commonly referred to as a composite account. For example, all the assets used in a business may be included in a single account. Group, classified, or composite accounts may be further broken down on the basis of location, dates of acquisition, cost, character, use, etc.

(b) When group, classified, or composite accounts are used with average useful lives and a normal retirement occurs, the full cost or other basis of the asset retired, unadjusted for depreciation or salvage, shall be removed from the asset account and shall be charged to the depreciation reserve. Amounts representing salvage ordinarily are credited to the depreciation reserve. Where an asset is disposed of for reasons other than normal retirement, the full cost or other basis of the asset shall be removed from the asset account, and the depreciation reserve shall be charged with the depreciation applicable to the retired asset. For rules with respect to losses on normal retirements, see § 1.167 (a)-8.

(c) A taxpayer may establish as many accounts for depreciable property as he desires. Depreciation allowances shall be computed separately for each account. Such depreciation preferably should be recorded in a depreciation reserve account; however, in appropriate cases it may be recorded directly in the asset account. Where depreciation reserves are maintained, a separate reserve account shall be maintained for each asset account. The regular books of account or permanent auxiliary records shall show for each account the basis of the property, including adjustments necessary to conform to the requirements of section 1016 and other provisions of law relating to adjustments to basis, and the depreciation allowances for tax purposes. In the event that reserves for book purposes do not correspond with reserves maintained for tax purposes, permanent auxiliary records shall be maintained with the regular books of accounts reconciling the differences in depreciation for tax and book purposes because of different methods of depreciation, bases, rates, salvage, or other factors. Depreciation schedules filed with the income tax return shall show the accumulated reserves computed in accordance with the allowances for income tax purposes.

(d) In classified or composite accounts, the average useful life and rate shall be redetermined whenever additions, retirements, or replacements substantially alter the relative proportion of types of assets in the accounts. See example (2) in paragraph (b) of § 1.167(b)-1 for method of determining the depreciation rate for a classified or composite account.

§ 1.167(a)-8 Retirements.

(a) *Gains and losses on retirements.* For the purposes of this section the term "retirement" means the permanent withdrawal of depreciable property from use in the trade or business or in the production of income. The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by actual abandonment. In addition, the asset may be withdrawn from such productive use without disposition as, for example, by being placed in a supplies or scrap account. The tax consequences of a retirement depend upon the form of the transaction, the reason therefor, the

timing of the retirement, the estimated useful life used in computing depreciation, and whether the asset is accounted for in a separate or multiple asset account. Upon the retirement of assets, the rules in this section apply in determining whether gain or loss will be recognized, the amount of such gain or loss, and the basis for determining gain or loss:

(1) Where an asset is retired by sale at arm's length, recognition of gain or loss will be subject to the provisions of sections 1002, 1231, and other applicable provisions of law.

(2) Where an asset is retired by exchange, the recognition of gain or loss will be subject to the provisions of sections 1002, 1031, 1231, and other applicable provisions of law.

(3) Where an asset is permanently retired from use in the trade or business or in the production of income but is not disposed of by the taxpayer or physically abandoned (as, for example, when the asset is transferred to a supplies or scrap account), gain will not be recognized. In such a case loss will be recognized measured by the excess of the adjusted basis of the asset at the time of retirement over the estimated salvage value or over the fair market value at the time of such retirement if greater, but only if—

(i) The retirement is an abnormal retirement, or

(ii) The retirement is a normal retirement from a single asset account (but see paragraph (d) of this section for special rule for item accounts), or

(iii) The retirement is a normal retirement from a multiple asset account in which the depreciation rate was based on the maximum expected life of the longest lived asset contained in the account.

(4) Where an asset is retired by actual physical abandonment (as, for example, in the case of a building condemned as unfit for further occupancy or other use), loss will be recognized measured by the amount of the adjusted basis of the asset abandoned at the time of such abandonment. In order to qualify for the recognition of loss from physical abandonment, the intent of the taxpayer must be irrevocably to discard the asset so that it will neither be used again by him nor retrieved by him for sale, exchange, or other disposition.

Experience with assets which have attained an exceptional or unusual age shall, with respect to similar assets, be disregarded in determining the maximum expected useful life of the longest lived asset in a multiple asset account. For example, if a manufacturer establishes a proper multiple asset account for 50 assets which are expected to have an average life of 30 years but which will remain useful to him for varying periods between 20 and 40 years, the maximum expected useful life will be 40 years, even though an occasional asset of this kind may last 60 years.

(b) *Definition of normal and abnormal retirements.* For the purpose of this section the determination of whether a retirement is normal or abnormal shall be made in the light of all the facts and circumstances. In general, a retirement shall be considered a normal retirement unless the taxpayer can show that the withdrawal of the asset was due to a cause not contemplated in setting the applicable depreciation rate. For example, a retirement is considered normal if made within the range of years taken into consideration in fixing the depreciation rate and if the asset has reached a condition at which, in the normal course of events, the taxpayer customarily retires similar assets from use in his business. On the other hand, a retirement may be abnormal if the asset is withdrawn at an earlier time or under other circumstances, as, for example, when the asset has been damaged by casualty or has lost its usefulness suddenly as the result of extraordinary obsolescence.

(c) *Basis of assets retired.* The basis of an asset at the time of retirement for computing gain or loss shall be its adjusted basis for determining gain or loss upon a sale or other disposition as determined in accordance with the provisions of section 1011 and the following rules:

(1) In the case of a normal retirement of an asset from a multiple asset account where the depreciation rate is based on average expected useful life,

the term "adjusted basis" means the salvage value estimated in determining the depreciation deduction in accordance with the provisions in paragraph (c) of § 1.167(a)-1.

(2) In the case of a normal retirement of an asset from a multiple asset account on which the depreciation rate was based on the maximum expected life of the longest lived asset in the account, the adjustment for depreciation allowed or allowable shall be made at the rate which would have been proper if the asset had been depreciated in a single asset account (under the method of depreciation used for the multiple asset account) using a rate based upon the maximum expected useful life of that asset, and

(3) In the case of an abnormal retirement from a multiple asset account the adjustment for depreciation allowed or allowable shall be made at the rate which would have been proper had the asset been depreciated in a single asset account (under the method of depreciation used for the multiple asset account) and using a rate based upon either the average expected useful life or the maximum expected useful life of the asset, depending upon the method of determining the rate of depreciation used in connection with the multiple asset account.

(d) *Special rule for item accounts.* (1) As indicated in paragraph (a)(3)(ii) and (iii) of this section, a loss is recognized upon the normal retirement of an asset from a single asset account but a loss on the normal retirement of an asset in a multiple asset account is not allowable where the depreciation rate is based upon the average useful life of the assets in the account. Where a taxpayer with more than one depreciable asset chooses to set up a separate account for each such asset and the depreciation rate is based on the average useful life of such assets (so that he uses the same life for each account), the question arises whether his depreciation deductions in substance are the equivalent of those which would result from the use of multiple asset accounts and, therefore, he should be subject to the rules governing losses on retirements of assets from multiple asset accounts. Where a taxpayer has only a few depreciable assets which he chooses to account for in single asset accounts, particularly where such assets cover a relatively narrow range of lives, it cannot be said in the usual case that the allowance of losses on retirements from such accounts clearly will distort income. This results from the fact that where a taxpayer has only a few depreciable assets it is usually not possible clearly to determine that the depreciation rate is based upon the average useful life of such assets. Accordingly, it cannot be said that the taxpayer is in effect clearly operating with a multiple asset account using an average life rate so that losses should not be allowed on normal retirements. Therefore, losses normally will be allowed upon retirement of assets from single asset accounts where the taxpayer has only a few depreciable assets. On the other hand, when a taxpayer who has only a few depreciable assets chooses to account for them in single asset accounts, using for each account a depreciation rate based on the average useful life of such assets, and the assets cover a wide range of lives, the likelihood that income will be distorted is greater than where the group of assets covers a relatively narrow range of lives. In those cases where the allowance of losses would distort income, the rules with respect to the allowance of losses on normal retirement shall be applied to such assets in the same manner as though the assets had been accounted for in multiple asset accounts using a rate based upon average expected useful life.

(2) Where a taxpayer has a large number of depreciable assets and depreciation is based on the average useful life of such assets, then, whether such assets are similar or dissimilar and regardless of whether they are accounted for in individual asset accounts or multiple asset accounts the allowance of losses on the normal retirement of such assets would distort income. Such distortion would result from the fact that the use of average useful life (and, accordingly, average rate) assumes that while some assets normally will be retired before the expiration of the average life, others normally will be retired after expira-

tion of the average life. Accordingly, if instead of accounting for a large number of similar or dissimilar depreciable assets in multiple asset accounts, the taxpayer chooses to account separately for such assets, using a rate based upon the average life of such assets, the rules with respect to the allowances of losses on normal retirements will be applied to such assets in the same manner as though the assets were accounted for in multiple asset accounts using a rate based upon average expected useful life.

(3) Where a taxpayer who does not have a large number of depreciable assets (and who therefore is not subject to subparagraph (2) of this paragraph) chooses to set up a separate account for each such asset, and has sought to compute an average life for such assets on which to base his depreciation deductions (so that he uses the same life for each account), the allowance of losses on normal retirements from such accounts may in some situations substantially distort income. Such distortion would result from the fact that the use of average useful life (and, accordingly, average rate) assumes that while some assets normally will be retired before expiration of the average life, others normally will be retired after expiration of the average life. Accordingly, where a taxpayer chooses to account separately for such assets instead of accounting for them in multiple asset accounts, and the result is to substantially distort his income, the rules with respect to the allowance of losses on normal retirements shall be applied to such assets in the same manner as though the assets had been accounted for in multiple asset accounts using a rate based upon average expected useful life.

(4) Whenever a taxpayer is treated under this paragraph as though his assets were accounted for in a multiple asset account using an average life rate, and, therefore, he is denied a loss on retirements, the unrecovered cost less salvage of each asset which was accounted for separately may be amortized in accordance with the regulation stated in paragraph (e)(1)(ii) of this section.

(e) *Accounting treatment of asset retirements.* (1) In the case of a normal retirement where under the foregoing rules no loss is recognized and where the asset is retired without disposition or abandonment, (i) if the asset was contained in a multiple asset account, the full cost of such asset, reduced by estimated salvage, shall be charged to the depreciation reserve, or (ii) if the asset was accounted for separately, the unrecovered cost or other basis, less salvage, of the asset may be amortized through annual deductions from gross income in amounts equal to the unrecovered cost or other basis of such asset, divided by the average expected useful life (not the remaining useful life) applicable to the asset at the time of retirement. For example, if an asset is retired after six years of use and at the time of retirement depreciation was being claimed on the basis of an average expected useful life of ten years, the unrecovered cost or other basis less salvage would be amortized through equal annual deductions over a period of ten years from the time of retirement.

(2) Where multiple asset accounts are used and acquisitions and retirements are numerous, if a taxpayer, in order to avoid unnecessarily detailed accounting for individual retirements, consistently follows the practice of charging the reserve with the full cost or other basis of assets retired and of crediting it with all receipts from salvage, the practice may be continued so long as, in the opinion of the Commissioner, it clearly reflects income. Conversely, where the taxpayer customarily follows a practice of reporting all receipts from salvage as ordinary taxable income such practice may be continued so long as, in the opinion of the Commissioner, it clearly reflects income.

(f) *Cross reference.* For special rules in connection with the retirement of the last assets of a given year's acquisitions under the declining balance method, see example (2) in paragraph (b) of § 1.167 (b)-2.

§ 1.167(a)-9 Obsolescence.

The depreciation allowance includes an allowance for normal obsolescence which should be taken into account to the extent that the expected useful

life of property will be shortened by reason thereof. Obsolescence may render an asset economically useless to the taxpayer regardless of its physical condition. Obsolescence is attributable to many causes, including technological improvements and reasonably foreseeable economic changes. Among these causes are normal progress of the arts and sciences, supersession or inadequacy brought about by developments in the industry, products, methods, markets, sources of supply, and other like changes, and legislative or regulatory action. In any case in which the taxpayer shows that the estimated useful life previously used should be shortened by reason of obsolescence greater than had been assumed in computing such estimated useful life, a change to a new and shorter estimated useful life computed in accordance with such showing will be permitted. No such change will be permitted merely because in the unsupported opinion of the taxpayer the property may become obsolete. For rules governing the allowance of a loss when the usefulness of depreciable property is suddenly terminated, see § 1.167(a)-8. If the estimated useful life and the depreciation rates have been the subject of a previous agreement, see section 167(d) and § 1.167(d)-1.

§ 1.167(a)-10 When depreciation deduction is allowable.

(a) A taxpayer should deduct the proper depreciation allowance each year and may not increase his depreciation allowances in later years by reason of his failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for such property or under the straight line method if no allowance has ever been claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section 167(b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account. For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. However, in the case of a multiple asset account, the amount of depreciation may be determined by using what is commonly described as an "averaging convention", that is, by using an assumed timing of additions and retirements. For example, it might be assumed that all additions and retirements to the asset account occur uniformly throughout the taxable year, in which case depreciation is computed on the average of the beginning and ending balances of the asset account for the taxable year. See example (3) under paragraph (b) of § 1.167 (b)-1. Among still other averaging conventions which may be used is the one under which it is assumed that all additions and retirements during the first half of a given year were made on the first day of that year and that all additions and retirements during the second half of the year were made on the first day of the following year. Thus, a full year's depreciation would be taken on additions in the first half of the year and no depreciation would be taken on additions in the second half. Moreover, under this convention, no depreciation would be taken on retirements in the first half of the year and a full year's depreciation would be taken on the retirements in the second half. An averaging convention, if used, must be consistently followed as to the account or accounts for which it is adopted, and must be applied to both additions and retirements. In any year in which an averaging convention substantially distorts the depreciation allowance for the taxable year, it may not be used.

§ 1.167(a)-11 Depreciation based on class lives and asset depreciation ranges for property placed in service after December 31, 1970.

(a) *In general*—(1) *Summary.* This section provides an asset depreciation range and class life system for determining the reasonable allowance for depreciation of designated classes of assets placed in service after December 31, 1970. The system is designed to minimize disputes between taxpayers and the Internal Revenue Service as to the useful life of property, and as to salvage value, repairs, and other matters. The system is optional with the taxpayer. The taxpayer has an annual election. Generally, an election for a taxable year must apply to all additions of eligible property during the taxable year of election, but does not apply to additions of eligible property in any other taxable year. The taxpayer's election, made with the return for the taxable year, may not be revoked or modified for any property included in the election. Generally, the taxpayer must establish vintage accounts for all eligible property included in the election, must determine the allowance for depreciation of such property in the taxable year of election, and in subsequent taxable years, on the basis of the asset depreciation period selected and must apply the first-year convention specified in the election to determine the allowance for depreciation of such property. This section also contains special provisions for the treatment of salvage value, retirements, and the costs of the repair, maintenance, rehabilitation or improvement of property. In general, a taxpayer may not apply any provision of this section unless he makes an election and thereby consents to, and agrees to apply, all the provisions of this section. A taxpayer who elects to apply this section does, however, have certain options as to the application of specified provisions of this section. A taxpayer may elect to apply this section for a taxable year only if for such taxable year he complies with the requirements of paragraph (f)(4) of this section.

(2) *Definitions.* For the meaning of certain terms used in this section, see paragraphs (b)(2) ("eligible property"), (b)(3) ("vintage account" and "vintage"), (b)(4) ("asset depreciation range", "asset guideline class", "asset guideline period", and "asset depreciation period"), (b)(5)(iii)(*c*) ("used property"), (b)(6)(i) ("public utility property"), (c)(1)(iv) ("original use"), (c)(1)(v) ("unadjusted basis" and "adjusted basis"), (c)(2)(ii) ("modified half-year convention"), (c)(2)(iii) ("half-year convention"), (d)(1)(i) ("gross salvage value"), (d)(1)(ii) ("salvage value"), (d)(2)(iii) ("repair allowance", "repair allowance percentage", and "repair allowance property"), (d)(2)(vi) ("excluded addition"), (d)(2)(vii) ("property improvement"), (d)(3)(ii) ("ordinary retirement" and "extraordinary retirement"), (d)(3)(vi) ("special basis vintage account"), and (e)(1) ("first placed in service") of this section.

(b) *Reasonable allowance using asset depreciation ranges*—(1) *In general.* The allowance for depreciation of eligible property (as defined in subparagraph (2) of this paragraph) to which the taxpayer elects to apply this section shall be determined as provided in paragraph (c) of this section and shall constitute the reasonable allowance for depreciation of such property under section 167(a).

(2) *Definition of eligible property.* For purposes of this section, the term "eligible property" means tangible property which is subject to the allowance for depreciation provided by section 167(a) but only if—

(i) An asset guideline class and asset guideline period are in effect for such property for the taxable year of election (see subparagraph (4) of this paragraph);

(ii) The property is first placed in service (as described in paragraph (e)(1) of this section) by the taxpayer after December 31, 1970 (but see subparagraph (7) of this paragraph for special rule where there is a mere change in the form of conducting a trade or business); and

(iii) The property is either—

(*a*) Section 1245 property as defined in section 1245(a)(3), or

(*b*) Section 1250 property as defined in section 1250(c).

See, however, subparagraph (6) of this paragraph for special rule for certain public utility property as defined in section 167(l)(3)(A). Property which meets the requirements of this subparagraph is eligible property even if depreciation with respect to such property, determined in accordance with this section, is allocated to or otherwise required to be reflected in the cost of a capitalized item. The term "eligible property" includes any property which meets the requirements of this subparagraph, whether such property is new property, "used property" (as described in subparagraph (5)(iii)(c) of this paragraph), a "property improvement" (as described in paragraph (d)(2)(vii) of this section), or an "excluded addition" (as described in paragraph (d)(2)(vi) of this section). For the treatment of expenditures for the repair, maintenance, rehabilitation or improvement of certain property, see paragraph (d) (2) of this section.

(3) *Requirement of vintage accounts*— (i) *In general.* For purposes of this section, a "vintage account" is a closed-end depreciation account containing eligible property to which the taxpayer elects to apply this section, first placed in service by the taxpayer during the taxable year of election. The "vintage" of an account refers to the taxable year during which the eligible property in the account is first placed in service by the taxpayer. Such an account will consist of an asset, or a group of assets, within a single asset guideline class established pursuant to subparagraph (4) of this paragraph and may contain only eligible property. Each item of eligible property to which the taxpayer elects to apply this section, first placed in service by the taxpayer during the taxable year of election (determined without regard to a convention described in paragraph (c)(2) of this section) shall be placed in a vintage account of the taxable year of election. For rule regarding "special basis vintage accounts" for certain property improvements, see paragraph (d)(2)(viii) and (3)(vi) of this section. Any number of vintage accounts of a taxable year may be established. More than one account of the same vintage may be established for different assets of the same asset guideline class. See paragraph (d)(3)(xi) of this section for special rule for treatment of certain multiple asset and item accounts.

(ii) *Special rule.* Section 1245 property may not be placed in a vintage account with section 1250 property. Property the original use of which does not commence with the taxpayer may not be placed in a vintage account with property the original use of which commences with the taxpayer. Property described in section 167(f)(2) may not be placed in a vintage account with property not described in section 167(f)(2). Property described in section 179(d)(1) for which the taxpayer elects the allowance for the first taxable year in accordance with section 179(c) may not be placed in a vintage account with property not described in section 179(d)(1) or for which the taxpayer does not elect such allowance for the first taxable year. For special rule for property acquired in a transaction to which section 381(a) applies, see paragraph (e)(3)(i) of this section. For additional rules with respect to accounting for eligible property, see paragraph (e) of this section.

(4) *Asset depreciation ranges and periods*—(i) *Selection of asset depreciation period.* The taxpayers books and records must specify for each vintage account of the taxable year of election—

(*a*) In the case of vintage account for property in an asset guideline class for which no asset depreciation range is in effect for the taxable year, the asset depreciation period (which shall be equal to the asset guideline period for the assets in such account), or

(*b*) In the case of a vintage account for property in an asset guideline class for which an asset depreciation range is in effect for the taxable year, the asset depreciation period selected by the taxpayer from the asset depreciation range for the assets in such account.

Unless otherwise expressly provided in the establishment thereof, for purposes of this section, the term "asset guideline class" means a category of assets (including "subsidiary assets") for which a separate asset guideline period is in effect for the taxable year

as provided in subdivision (ii) of this subparagraph. The "asset depreciation range" is a period of years which extends from 80 percent of the asset guideline period to 120 percent of such period, determined in each case by rounding any fractional part of a year to the nearer of the nearest whole or half year. Except as provided in paragraph (e)(3)(iv) of this section, in the case of an asset guideline class for which an asset depreciation range is in effect, any period within the asset depreciation range for the assets in a vintage account which is a whole number of years or a whole number of years plus a half year, may be selected. The term "asset depreciation period" means the period selected from the asset depreciation range, or if no asset depreciation range is in effect for the class, the asset guideline period. The "asset guideline period" is established in accordance with subdivision (ii) of this subparagraph and is the class life under section 167(m). See Revenue Procedure 72-10 for special rules for section 1250 property and property predominately used outside the United States. In general, an asset guideline period, but no asset depreciation range, is in effect for such property.

(ii) *Establishment of asset guideline classes and periods.* The asset guideline classes and the asset guideline periods, and the asset depreciation ranges determined from such periods, in effect for taxable years ending before the effective date of the first supplemental asset guideline classes, asset guideline periods, and asset depreciation ranges, established pursuant to this section are set forth in Revenue Procedure 72-10. Asset guideline classes and periods, and asset depreciation ranges, will from time to time be established, supplemented, and revised with express reference to this section, and will be published in the Internal Revenue Bulletin. The asset guideline classes, the asset guideline periods, and the asset depreciation ranges determined from such periods in effect as of the last day of a taxable year of election shall apply to all vintage accounts of such taxable year, except that neither the asset guideline period nor the lower limit of the asset depreciation range for any such account shall be longer than the asset guideline period or the lower limit of the asset depreciation range, as the case may be, for such account in effect as of the first day of the taxable year (or as of such later time in such year as an asset guideline class first established during such year becomes effective). Generally, the reasonable allowance for depreciation of property for any taxable year in a vintage account shall not be changed to reflect any supplement or revision of the asset guideline classes or periods, and asset depreciation ranges, for the taxable year in which the account is established, which occurs after the end of such taxable year. However, if expressly provided in such a supplement or revision, the taxpayer may, at his option in the manner specified therein, apply the revised or supplemented asset guideline classes or periods and asset depreciation ranges to such property for such taxable year and succeeding taxable years.

(iii) *Applicable guideline classes and periods in special situations.* (*a*) An electric or gas utility which would in accordance with Revenue Procedure 64-21 be entitled to use a composite guideline class basis for applying Revenue Procedure 62-21 may, solely with respect to property for which an asset depreciation range is in effect for the taxable year, elect to apply this section on the basis of a composite asset guideline class and asset guideline period determined by applying the provisions of Revenue Procedure 64-21 to such property. The asset depreciation range for such a composite asset guideline class shall be determined by reference to the composite asset guideline period at the beginning of the first taxable year to which the taxpayer elects to apply this section and shall not be changed until such time as major variations in the asset mix or the asset guideline classes or periods justify some other composite asset guideline period. Except as provided in paragraph (d)(2)(iii) of this section with respect to buildings and other structures, for the purposes of this section, all property in the composite asset guideline class shall be treated as included in a single asset guideline

class. If the taxpayer elects to apply this subdivision, the election shall be made on the tax return filed for the first taxable year for which the taxpayer elects to apply this section. An election to apply this subdivision for any taxable year shall apply to all succeeding taxable years to which the taxpayer elects to apply this section, except to the extent the election to apply this subdivision is with the consent of the Commissioner terminated with respect to a succeeding taxable year and all taxable years thereafter.

(*b*) For purposes of this section, property shall be included in the asset guideline class for the activity in which the property is primarily used. See paragraph (e)(3)(iii) of this section for rule for leased property. Property shall be classified according to primary use even though the activity in which such property is primarily used is insubstantial in relation to all the taxpayer's activities. No change in the classification of property shall be made because of a change in primary use after the end of the taxable year in which property is first placed in service, including a change in use which results in section 1250 property becoming section 1245 property.

(*c*) An incorrect classification or characterization by the taxpayer of property for the purposes of this section (such as under (*b*) of this subdivision or under subparagraph (2) or (3)(ii) of this paragraph) shall not cause or permit a revocation of the election to apply this section for the taxable year in which such property was first placed in service. The classification or characterization of such property shall be corrected. All adjustments necessary to the correction shall be made, including adjustments of unadjusted basis, adjusted basis, salvage value, the reserve for depreciation of all vintage accounts affected, and the amount of depreciation allowable for all taxable years for which the period for assessment of tax prescribed in section 6501 has not expired. If because of incorrect classification or characterization property included in an election to apply this section was not placed in a vintage account and no asset depreciation period was selected for the property or the property was placed in a vintage account but an asset depreciation period was selected from an incorrect asset depreciation range, the taxpayer shall place the property in a vintage account and select an asset depreciation period for the account from the correct asset depreciation range.

(*d*) Generally, except as provided in subparagraph (5)(v)(*a*) of this paragraph, a taxpayer may not compute depreciation for eligible property first placed in service during the taxable year under a method of depreciation not described in section 167(b) (1), (2), or (3). (If the taxpayer computes depreciation with respect to such property under section 167(k), or amortizes such property, the property must be excluded from the election to apply this section.) (See subparagraph (5)(v)(*b*) of this paragraph.) However, if the taxpayer establishes to the satisfaction of the Commissioner that a method of depreciation not described in section 167(b) (1), (2), (3), or (k) was adopted for property in the asset guideline class on the basis of a good faith mistake as to the proper asset guideline class for the property, then, unless the requirements of subparagraph (5)(v) (*a*) of this paragraph are met, the taxpayer must terminate (as of the beginning of the taxable year) such method of depreciation with respect to all eligible property in the asset guideline class which was first placed in service during the taxable year. In such event, the taxpayer's election to apply this section shall include eligible property in the asset guideline class without regard to subparagraph (5)(v)(*a*) of this paragraph. The provisions of (*c*) of this subdivision shall apply to the correction in the classification of the property.

(*e*) If the provisions of section 167(j) apply to require a change in the method of depreciation with respect to an item of section 1250 property in a multiple asset vintage account, the asset shall be removed from the account and placed in a separate item vintage account. The unadjusted basis of the asset shall be removed from the unadjusted basis of the vintage account as of the first day of the taxable year in which the change in method of depreciation is required and the depre-

ciation reserve established for the account shall be reduced by the depreciation allowable for the property computed in the manner prescribed in paragraph (c)(1)(v)(*b*) of this section for determination of the adjusted basis of property. See paragraph (d)(3)(vii)(*e*) of this section for treatment of salvage value when property is removed from a vintage account.

(iv) ***Examples.*** The principles of this subparagraph may be illustrated by the following examples:

Example (1).—Corporation X purchases a bulldozer for the use in its construction business. The bulldozer is first placed in service in 1972. Since the bulldozer is tangible property for which an asset guideline class and period have been established, the bulldozer is eligible property. The bulldozer is in asset guideline class 15.1 of Revenue Procedure 72-10, and the asset depreciation range is 4-6 years.

Example (2).—In 1972, corporation Y first places in service a factory building. Since the factory building is tangible property for which an asset guideline class and period have been established, it is eligible property. The factory building is in asset guideline class 65.11 of Revenue Procedure 72-10. Since no asset depreciation range is in effect for the asset guideline class, the asset depreciation period is the asset guideline period of 45 years. (See subparagraph (5)(vi) of this paragraph for election to exclude certain section 1250 property during transition period.)

Example (3).—In January of 1971, corporation Y, a calendar year taxpayer, pays or incurs $2,000 for the rehabilitation and improvement of machine A which was first placed in service in 1969. On January 1, 1971, corporation Y first placed in service machines B and C, each with an unadjusted basis of $10,000. Machines B and C are eligible property. Machine A would be eligible property but for the fact it was first placed in service prior to January 1, 1971 (that is, machine A is eligible property determined without regard to subparagraph (2)(ii) of this paragraph). Corporation Y elects to apply this section for the taxable year, and adopts the modified half-year convention described in paragraph (c)(2)(ii) of this section, but does not elect to apply the asset guideline class repair allowance described in paragraph (d)(2)(iii) of this section. Machines A, B, and C are in asset guideline class 24.4 under Revenue Procedure 72-10 for which the asset depreciation range is 8 to 12 years. The $2,000 expended on machine A substantially increases its capacity and is a capital expenditure under sections 162 and 263. The $2,000 is a property improvement (as defined in paragraph (d)(2)(vii)(*b*) of this section) which is eligible property. However, corporation Y by mistake treats the property improvement of $2,000 as a deductible repair. Also by mistake, corporation Y includes machine B in asset guideline class 24.3 under Revenue Procedure 72-10 for which the asset depreciation range is 5 to 7 years. Corporation Y establishes vintage accounts for 1971, and computes depreciation for 1971 and 1972 as follows:

	Dec. 31, 1972, reserve for depreciation	Dec. 31, 1972, adjusted basis
Vintage account for machine B, with an asset depreciation period of 5 years and an unadjusted basis of $10,000 for which corporation Y adopts the straight line method	$4,000	$6,000
Vintage account for machine C, with an asset depreciation period of 8 years and an unadjusted basis of $10,000 for which corporation Y adopts the straight line method	2,500	7,500

After audit in 1973 of corporation Y's taxable years 1971 and 1972, it is determined that the $2,000 paid in 1971 for the rehabilitation and improvement of machine A is a capital expenditure and that machine B is in asset guideline class 24.4. The incorrect classification is corrected. Corporation Y places machine B and the property improvement in a vintage account of 1971 and on its tax return filed for 1973 selects an asset depreciation period of 8 years for that account. Giving effect to the correction in classification of the property in accordance with subdivision (iii) (*c*) of this subparagraph, at the end of 1972 the unadjusted basis, reserve for depreciation, and adjusted basis of the vintage account for machine B and the property improvement with respect to machine A are $12,000, $3,000, and $9,000, respectively. Corporation Y's deduction of the $2,000 property improvement in 1971 as a repair expense under section 162 is disallowed. For 1971 and 1972 depreciation deductions are disallowed in the amount of $500 each year (that is, $750 excess annual depreciation on machine B minus $250 annual depreciation on the property improvement).

Example (4). (*a*) In 1971, Corporation X, a calendar year taxpayer, first places in service machines A through M, all of which are eligible property. All the machines except machine A are in asset guideline class 24.3 under Revenue Procedure 72-10. Machine A is in asset guideline class 24.4 under Reve-

nue Procedure 72-10. Machine B has an unadjusted basis equal to 80 percent of the total unadjusted basis of machines B through M. By good faith mistake as to proper classification, corporation X includes both machine A and machine B in asset guideline class 24.4. Corporation X consistently uses the machine hour method of depreciation on all property in asset guideline class 24.4, and for 1971 computes depreciation for machines A and B under that method. Corporation X elects to apply this section for 1971 on the assumption that the election includes machines C through M which are in asset guideline class 24.3. In 1973, upon audit of corporation X's taxable years 1971 and 1972, it is determined that machine B is included in asset guideline class 24.3 and that since for 1971 corporation X computed depreciation on machine B under the machine hour method, in accordance with subparagraph (5)(v) (*a*) of this paragraph, all property in asset guideline class 24.3 (machines B through M) is excluded from corporation X's election to apply this section for 1971. Although corporation X has consistently used the machine hour method for asset guideline class 24.4, corporation X has not in the past used the machine hour method for machines of the type and function of machines C through M which are in asset guideline class 24.3. Both machine A and machine B are used in connection with the manufacture of wood products. There is reasonable basis for corporation X having assumed that machine B is in asset guideline class 24.4 along with machine A to which it is similar. Corporation X establishes to the satisfaction of the Commissioner that it used the machine hour method for machine B on the basis of a good faith mistake as to the proper classification of the machine. Corporation X may, at its option (see subparagraph (5)(v) of this paragraph), terminate the machine hour method of depreciation for machine B as of the beginning of 1971, and in that event corporation X's election to apply this section for 1971 will apply to machines B through M without regard to subparagraph (5)(v)(*a*) of this paragraph. The adjustments provided in subdivision (iii)(*c*) of this subparagraph will be made as a result of the correction in classification of property. If corporation X does not terminate the machine hour method with respect to machine B, machines B through M must be excluded from the election to apply this section (see subparagraph (5)(v) of this paragraph).

(*b*) The facts are the same as in (*a*) of this example except that machine B has an unadjusted basis equal to only 65 percent of the total unadjusted basis of machines B through M.

In this case, corporation X must either terminate the machine hour method of depreciation with respect to asset B (since the provisions of subparagraph (5)(v) of this paragraph do not permit the exclusion of the property from the election to apply this section) or otherwise comply with the provisions of subparagraph (5)(v) of this paragraph. (See paragraph (c)(1)(iv) for limitation on methods which may be adopted for property included in the election to apply this section.)

(5) *Requirements of election*—(i) *In general.* Except as otherwise provided in paragraph (d)(2) of this section dealing with expenditures for the repair, maintenance, rehabilitation or improvement of certain property, no provision of this section shall apply to any property other than eligible property to which the taxpayer elects in accordance with this section, to apply this section. For the time and manner of election, and certain conditions to an election, see paragraph (f) of this section. Except as otherwise provided in subparagraph (4)(iii) of this paragraph, subdivision (v) of this subparagraph and in subparagraph (6)(iii) of this paragraph, a taxpayer's election to apply this section may not be revoked or modified after the last day prescribed for filing the election. Thus, for example, after such day, a taxpayer may not cease to apply this section to property included in the election, establish different vintage accounts for the taxable year of election, select a different period from the asset depreciation range for any such account, or adopt a different first-year convention for any such account.

(ii) *Property required to be included in election.* Except as otherwise provided in subdivision (iii) of this subparagraph dealing with certain "used property", in subdivision (iv) of this subparagraph dealing with "section 38 property", in subdivision (v) of this subparagraph dealing with property subject to special depreciation or amortization, in subdivision (vi) of this subparagraph dealing with certain section 1250 property, in subdivision (vii) of this subparagraph dealing with certain subsidiary assets, and in paragraph (e)(3) (i) and (iv) of this section dealing with transactions to which section 381(a) applies, if the taxpayer elects to apply this section to any eligible property first placed in service by the taxpayer during the taxable year

of election, the election shall apply to all such eligible property, whether placed in service in a trade or business or held for production of income.

(iii) *Special 10 percent used property rule.* (*a*) If (*1*) the unadjusted basis of eligible used section 1245 property (as defined in (*c*) of this subdivision) first placed in service by the taxpayer during the taxable year of election, for which no specific used property asset guideline class (as defined in (*c*) of this subdivision) is in effect for the taxable year, exceeds (*2*) 10 percent of the unadjusted basis of all eligible section 1245 property first placed in service during the taxable year of election, the taxpayer may exclude all (but not less than all) the property described in (*a*) (*1*) of this subdivision from the election to apply this section.

(*b*) If (*1*) the unadjusted basis of eligible used section 1250 property first placed in service by the taxpayer during the taxable year of election, for which no specific used property asset guideline class is in effect for the taxable year, exceeds (*2*) 10 percent of the unadjusted basis of all eligible section 1250 property first placed in service during the taxable year of election, the taxpayer may exclude all (but not less than all) the property described in (*b*)(*1*) of this subdivision from the election to apply this section.

(*c*) For the purposes of this section, the term "used property" means property the original use of which does not commence with the taxpayer. Solely for the purpose of determining whether the 10 percent rule of this subdivision is satisfied, (*1*) eligible used property first placed in service during the taxable year and excluded from the election to apply this section pursuant to subdivision (v)(*a*) of this subparagraph and (2) eligible property acquired during the taxable year in a transaction to which section 381(a) applies, shall all be treated as used property regardless of whether such property would be treated as new property under section 167(c) and the regulations thereunder. The term "specific used property asset guideline class" means a class established in accordance with subparagraph (4) of this paragraph solely for used property primarily used in connection with the activity to which the class relates.

(iv) *Property subject to investment tax credit.* The taxpayer may exclude from an election to apply this section all, or less than all, units of eligible property first placed in service during the taxable year which is—

(*a*) "Section 38 property" as defined in section 48(a) which meets the requirements of section 49 and which is not property described in section 50, or

(*b*) Property to which section 47(a)(5)(B) applies which would be section 38 property but for section 49 and which is placed in service to replace section 38 property (other than property described in section 50) disposed of prior to August 15, 1971.

(v) *Property subject to special method of depreciation or authorization.* (*a*) In the case of eligible property first placed in service in a taxable year of election (and not otherwise properly excluded from an election to apply this section) the taxpayer may not compute depreciation for any of such property in the asset guideline class under a method not described in section 167(b) (1), (2), (3), or (k) unless he (*1*) computes depreciation under a method or methods not so described for eligible property first placed in service in the taxable year in the asset guideline class with an unadjusted basis at least equal to 75 percent of the unadjusted basis of all eligible property first placed in service in the taxable year in the asset guideline class and (*2*) agrees to continue to depreciate such property under such method or methods until the consent of the Commissioner is obtained to a change in method. The consent of the Commissioner must be obtained by filing Form 3115 with the Commissioner of Internal Revenue, Washington, D.C. 20224, within the first 180 days of the taxable year for which the change is desired. If for the taxable year of election the taxpayer computes depreciation under any method not described in section 167(b) (1), (2), (3), or (k) for any eligible property (other than property otherwise properly excluded from an election to apply this section) first placed in service during the taxable year, an election to apply

this section for the taxable year shall not include such property or any other eligible property in the same asset guideline class as such property. With respect to a taxable year beginning before January 1, 1973, if the taxpayer has adopted a method of depreciation which is not permitted under this subdivision, the taxpayer may under this section adopt a method of depreciation permitted under this subdivision or otherwise comply with the provisions of this subdivision.

(*b*) An election to apply this section shall not include eligible property for which, for the taxable year of election, the taxpayer computes depreciation under section 167(k), or computes amortization under section 169, 184, 185, 187, 188, or paragraph (b) of § 1.162-11. If the taxpayer has elected to apply this section to eligible property described in section 167(k), 169, 184, 185, or 187 and the taxpayer thereafter computes depreciation or amortization for such property for any taxable year in accordance with section 167(k), 169, 184, 185, or 187, then the election to apply this section to such property shall terminate as of the beginning of the taxable year for which depreciation or amortization is computed under such section. Application of this section to the property for any period prior to the termination date will not be affected by the termination. The unadjusted basis of the property shall be removed as of the termination date from the unadjusted basis of the vintage account. The depreciation reserve established for the account shall be reduced by the depreciation allowable for the property, computed in the manner prescribed in paragraph (c)(1)(v)(*b*) of this section for determination of the adjusted basis of the property. See paragraph (d)(3)(vii)(*e*) of this section for treatment of salvage value when property is removed from a vintage account.

(vi) *Certain section 1250 property.* (*a*) The taxpayer may exclude from an election to apply this section all, or less than all, items of eligible section 1250 property first placed in service during the taxable year of election provided that—

(*1*) The item is first placed in service before the earlier of the effective date of the first supplemental asset guideline class including such property established in accordance with subparagraph (4)(ii) of this paragraph, or January 1, 1974, and

(*2*) The taxpayer establishes that a useful life shorter than the asset guideline period in effect on January 1, 1971, for such item of property is justified for such taxable year.

A useful life shorter than the asset guideline period in effect on January 1, 1971, will be considered justified only if such life is justified in accordance with the provisions of Revenue Procedure 62-21 (including all modifications, amendments or supplements thereto as of January 1, 1971), determined without application of the minimal adjustment rule in section 4, part II, of Revenue Procedure 65-13. If an item of section 1250 property is excluded from an election to apply this section pursuant to this subdivision, any elevator or escalator which is a part of such item shall also be excluded from the election.

(*b*) If the taxpayer excludes an item of section 1250 property from an election to apply this section in accordance with this subdivision, the useful life justified under Revenue Procedure 62-21 in accordance with this subdivision for the taxable year of exclusion will be treated as justified for such item of section 1250 property for the taxable year of the exclusion and all subsequent taxable years.

(vii) *Subsidiary assets.* The taxpayer may exclude from an election to apply this section all (but not less than all) subsidiary assets first placed in service during the taxable year of election in an asset guideline class, provided that—

(*a*) The unadjusted basis of eligible subsidiary assets first placed in service during the taxable year in the class is as much as 3 percent of the unadjusted basis of all eligible property first placed in service during the taxable year in the class, and

(*b*) Such subsidiary assets are first placed in service by the taxpayer before the earlier of (*1*) the effective date of the first supplemental asset guideline class including such subsidiary assets established in accordance

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with subparagraph (4)(ii) of this paragraph, or (*2*) January 1, 1974.

For purposes of this subdivision the term "subsidiary assets" includes jigs, dies, molds, returnable containers, glassware, silverware, textile mill cam assemblies, and other equipment included in group 1, class 5, of Revenue Procedure 62-21. which is usually and property accounted for separately from other property and under a method of depreciation not expressed in terms of years.

(6) *Special rule for certain public utility property*—(i) *Requirement of normalization in certain cases.* Under section 167(1), in the case of public utility property (as defined in section 167(1)(3)(A)), if the taxpayer—

(*a*) Is entitled to use a method of depreciation other than a "subsection (1) method" of depreciation (as defined in section 167(1)(3)(F)) only if it uses the "normalization method of accounting" (as defined in section 167(1)(3)(G)) with respect to such property, or

(*b*) Is entitled for the taxable year to use only a "subsection (1) method" of depreciation, such property shall be eligible property (as defined in subparagraph (2) of this paragraph) only if the taxpayer normalizes the tax deferral resulting from the election to apply this section.

(ii) *Normalization.* The taxpayer will be considered to normalize the tax deferral resulting from the election to apply this section only if it computes its tax expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using a period for depreciation no less than the lesser of—

(*a*) 100 percent of the asset guideline period in effect in accordance with subparagraph (4)(ii) of this paragraph for the first taxable year to which this section applies, or

(*b*) The period for computing its depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account, and makes adjustments to a reserve to reflect the deferral of taxes resulting from the election to apply this section. A determination whether the taxpayer is considered to normalize (within the meaning of the preceding sentence) the tax deferral resulting from the election to apply this section shall be made in a manner consistent with the principles for determining whether a taxpayer is using the "normalization method of accounting" (within the meaning of section 167(1)(3)(G)). [Removed] See § 1.167(1)-1(h).

(iii) *Failure to normalize.* If a taxpayer, which has elected to apply this section to any eligible public utility property and is required under subdivision (i) of this subparagraph to normalize the tax deferral resulting from the election to apply this section to such property, fails to normalize such tax deferral, the election to apply this section to such property shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize such tax deferral. Application of this section to such property for any period prior to the termination date will not be affected by the termination. The unadjusted basis of the property shall be removed as of the termination date from the unadjusted basis of the vintage account. The depreciation reserve established for the account shall be reduced by the depreciation allowable for the property, computed in the manner prescribed in paragraph (c)(1)(v)(*b*) of this section for determination of the adjusted basis of the property. See paragraph (d)(3)(vii)(*e*) of this section for treatment of salvage value when property is removed from a vintage account.

(iv) *Examples.* The principles of this subparagraph may be illustrated by the following examples:

Example (1). Corporation A is a gas pipeline company, subject to the jurisdiction of the Federal Power Commission, which is entitled under section 167(1) to use a method of depreciation other than a "subsection (1) method" of depreciation (as defined in section 167(1) (3) (F)) only if it uses the "normalization method of accounting" (as defined in section 167(1)(3)(G)). Corporation A elects to apply this section for 1972 with respect to all eligible property. In 1972, corporation A places in service eligible property with an unadjusted basis of $2 million. One hundred percent of the asset guideline period for such property is 22 years and the asset depreciation range is from 17.5 years to 26.5 years. The taxpayer uses the double declining balance method of depreciation,

selects an asset depreciation period of 17.5 years and applies the half-year convention (described in paragraph (c)(2)(iii) of this section). The depreciation allowable under this section with respect to such property in 1972 is $114,285. The taxpayer will be considered to normalize the tax deferral resulting from the election to apply this section and to use the "normalization method of accounting" (within the meaning of section 167(l)(3)(G)) if it computes its tax expense for purposes of determining its cost of service for rate making purposes and for reflecting operating results in its regulated books of account using a "subsection (l) method" of depreciation, such as the straight line method, determined by using a depreciation period of 22 years (that is, 100 percent of the asset guideline period). A depreciation allowance computed in this manner is $45,454. The difference in the amount determined under this section ($114,285) and the amount used in computing its tax expense for purposes of estimating its cost of service for rate making purposes and for reflecting operating results in its regulated books of account ($45,454) is $68,831. Assuming a tax rate of 48 percent, the deferral of taxes resulting from an election to apply this section and using a different method of depreciation for tax purposes from that used for establishing its cost of service for rate making purposes and for reflecting operating results in its regulated books of account is 48 percent of $68,831, or $33,039, which amount should be added to a reserve to reflect the deferral of taxes resulting from the election to apply this section and from the use of a different method of depreciation in computing the allowance for depreciation under section 167 from that used in computing its depreciation expense for purposes of establishing its cost of service for rate making purposes and for reflecting operating results in its regulated books of account.

Example (2). Corporation B, a telephone company subject to the jurisdiction of the Federal Communications Commission used a "flow-through method of accounting" (as defined in section 167(l)(3)(H)) for its "July 1969 accounting period" (as defined in section 167(l)(3)(I)) with respect to all of its pre-1970 public utility property and did not make an election under section 167(l)(4)(A). Thus, corporation B is entitled under section 167(l) to use a method of depreciation other than a "subsection (l) method" with respect to certain property without using the "normalization method of accounting." In 1972, corporation B makes an election to apply this section with respect to all eligible property. Corporation B is not required to normalize the tax deferral resulting from the election to apply this section in the case of property for which it is not required to use the "normalization method of accounting" under section 167(l).

Example (3). Assume the same facts as in example (2) except that corporation B made a timely election under section 167(l)(4)(A) that section 167(l)(2)(C) not apply with respect to property which increases the productive or operational capacity of the taxpayer. Corporation B must normalize the tax deferral resulting from the election to apply this section with respect to such property.

(7) *Mere change in form of conducting a trade or business.* Property which was first placed in service by the transferor before January 1, 1971, shall not be eligible property if such property is first placed in service by the transferee after December 31, 1970, by reason of a mere change in the form of conducting a trade or business in which such property is used. A mere change in the form of conducting a trade or business in which such property is used will be considered to have occurred if—

(i) The transferor (or in a case where the transferor is a partnership, estate, trust, or corporation, the partners, beneficiaries, or shareholders) of such property retains a substantial interest in such trade or business, or

(ii) The basis of such property in the hands of the transferee is determined in whole or in part by reference to the basis of such property in the hands of the transferor.

For purposes of this subparagraph, a transferor (or in a case where the transferor is a partnership, estate, trust, or corporation, the partners, beneficiaries, or shareholders) shall be considered as having retained a substantial interest in the trade or business only if, after the change in form, his (or their) interest in such trade or business is substantial in relation to the total interest of all persons in such trade or business. This subparagraph shall apply to property first placed in service prior to January 1, 1971, held for the production of income (within the meaning of section 167(a)(2)) as well as to property used in a trade or business. The principles of this subdivision may be illustrated by the following examples:

Example (1). Corporation X and corporation Y are includible corporations in an af-

filiated group as defined in section 1504(a). In 1971 corporation X sells property to corporation Y for cash. The property would meet the requirements of subparagraph (2) of this paragraph for eligible property except that it was first placed in service by corporation X in 1970. After the transfer, the property is first placed in service by corporation Y in 1971. The property is not eligible property because of the mere change in the form of conducting a trade or business.

Example (2). In 1971, in a transaction to which section 351 applies, taxpayer B transfers to corporation W property which would meet the requirements of subparagraph (2) of this paragraph for eligible property except that the property was first placed in service by B in 1969. Corporation W first places the property in service in 1971. The property is not eligible property because of the mere change in the form of conducting a trade or business.

(c) *Manner of determining allowance*—(1) *In general*—(i) *Computation of allowance.* (*a*) The allowance for depreciation of property in a vintage account shall be determined in the manner specified in this paragraph by using the method of depreciation adopted by the taxpayer for the account and a rate based upon the asset depreciation period for the account. (For limitations on methods of depreciation permitted with respect to property, see section 167 (c) and (j) and subdivision (iv) of this subparagraph.) In applying the method of depreciation adopted by the taxpayer, the annual allowance for depreciation of a vintage account shall be determined without adjustment for the salvage value of the property in such account except that no account may be depreciated below the reasonable salvage value of the account. (For rules regarding estimation and treatment of salvage value, see paragraph (d)(1) and (3) (vii) and (viii) of this section.) Regardless of the method of depreciation adopted by the taxpayer, the depreciation allowable for a taxable year with respect to a vintage account may not exceed the amount by which (as of the beginning of the taxable year) the unadjusted basis of the account exceeds (*1*) the reserve for depreciation established for the account plus (*2*) the salvage value of the account. The unadjusted basis of a vintage account is defined in subdivision (v) of this subparagraph. The adjustments to the depreciation reserve are described in subdivision (ii) of this subparagraph.

(*b*) The annual allowance for depreciation of a vintage account using the straight line method of depreciation shall be determined by dividing the unadjusted basis of the vintage account (without reduction for salvage value) by the number of years in the asset depreciation period selected for the account. See subdivision (iii)(*b*) of this subparagraph for the manner of computing the depreciation allowance following a change from the declining balance method or the sum of the years-digits method to the straight line method.

(*c*) In the case of the sum of the years-digits method, the annual allowance for depreciation of a vintage account shall be computed by multiplying the unadjusted basis of the vintage account (without reduction for salvage value) by a fraction, the numerator of which changes each year to a number which corresponds to the years remaining in the asset depreciation period for the account (including the year for which the allowance is being computed) and the denominator of which is the sum of all the year's digits corresponding to the asset depreciation period for the account. See subdivision (iii)(*c*) of this subparagraph for the manner of computing the depreciation allowance following a change from the declining balance method to the sum of the years-digits method.

(*d*) The annual allowance for depreciation of a vintage account using a declining balance method is determined by applying a uniform rate to the excess of the unadjusted basis of the vintage account over the depreciation reserve established for that account. The rate under the declining balance method may not exceed twice the straight line rate based upon the asset depreciation period for the vintage account.

(*e*) The allowance for depreciation under this paragraph shall constitute the amount of depreciation allowable under section 167. See section 179 for additional first-year allowance for certain property.

(ii) *Establishment of depreciation reserve.* The taxpayer must establish a depreciation reserve for each vintage account. The amount of the reserve for a guideline class must be stated on each income tax return on which depreciation with respect to such class is determined under this section. The depreciation reserve for a vintage account consists of the accumulated depreciation allowable under this section with respect to the vintage account, increased by the adjustments for ordinary retirements prescribed by paragraph (d)(3)(iii) of this section, by the adjustments for reduction of the salvage value of a vintage account prescribed by paragraph (d)(3)(vii)(*d*) of this section, and by the adjustments for transfers to supplies or scrap prescribed by paragraph (d)(3)(viii)(*b*) of this section, and decreased by the adjustments for extraordinary retirements and certain special retirements as prescribed by paragraph (d)(3) (iv) and (v) of this section, by the adjustments for the amount of the reserve in excess of the unadjusted basis of a vintage account prescribed by paragraph (d) (3) (ix) (*a*) of this section, and by the adjustments for property removed from a vintage account prescribed by paragraph (b)(4)(iii)(*e*), (5)(v)(*b*) and (6)(iii) of this section. The adjustments to the depreciation reserve for ordinary retirements during the taxable year shall be made as of the beginning of the taxable year. The adjustments to the depreciation reserve for extraordinary retirements shall be made as of the date the retirement is treated as having occurred in accordance with the first-year convention (described in subparagraph (2) of this paragraph) adopted by the taxpayer for the vintage account. The adjustment to the depreciation reserve for reduction of salvage value and for transfers to supplies or scrap shall, in the case of an ordinary retirement, be made as of the beginning of the taxable year, and in the case of an extraordinary retirement the adjustment for reduction of salvage value shall be made as of the date the retirement is treated as having occurred in accordance with the first-year convention (described in subparagraph (2) of this paragraph) adopted by the taxpayer for the vintage account. The adjustment to the depreciation reserve for property removed from a vintage account in accordance with paragraph (b)(4)(iii)(*e*), (5)(v)(*b*) and (6)(iii) of this section shall be made as of the beginning of the taxable year. The depreciation reserve of a vintage account may not be decreased below zero.

(iii) *Consent to change in method of depreciation.* (*a*) During the asset depreciation period for a vintage account, the taxpayer is permitted to change under this section from a declining balance method of depreciation to the sum of the years-digits method of depreciation and from a declining balance method of depreciation or the sum of the years-digits method of depreciation to the straight line method of depreciation with respect to such account. Except as provided in section 167(j)(2)(1), and paragraph (e)(3)(i) of this section, no other changes in the method of depreciation adopted for a vintage account will be permitted. The provisions of § 1.167(e)-1 shall not apply to any change in depreciation method permitted under this section. The change in method applies to all property in the vintage account and must be adhered to for the entire taxable year of the change.

(*b*) When a change is made to the straight line method of depreciation, the annual allowance for depreciation of the vintage account shall be determined by dividing the adjusted basis of the vintage account (without reduction for salvage value) by the number of years remaining (at the time as of which the change is made) in the asset depreciation period selected for the account. However, the depreciation allowable for any taxable year following a change to the straight line method may not exceed an amount determined by dividing the unadjusted basis of the vintage account (without reduction for salvage value) by the number of years in the asset depreciation period selected for the account.

(*c*) When a change is made from the declining balance method of depreciation to the sum of the years-digits method of depreciation, the annual allowance for depreciation of a vintage account shall be determined by multiplying the adjusted basis of the ac-

count (without reduction for salvage value) at the time as of which the change is made by a fraction, the numerator of which changes each year to a number which corresponds to the number of years remaining in the asset depreciation period selected for the account (including the year for which the allowance is being computed), and the denominator of which is the sum of all the year's digits corresponding to the number of years remaining in the asset depreciation period at the time as of which the change is made.

(*d*) The number of years remaining in the asset depreciation period selected for an account is equal to the asset depreciation period less the number of years of depreciation previously allowed. For this purpose, regardless of the first year convention adopted by the taxpayer, it will be assumed that depreciation was allowed for one-half of a year in the first year.

(*e*) The taxpayer shall furnish a statement setting forth the vintage accounts for which the change is made with the income tax return filed for the taxable year of the change.

(*f*) The principles of this subdivision may be illustrated by the following examples:

Example (1). A, a calendar year taxpayer, places new section 1245 property in service in a trade or business as follows:

Asset	Placed in service	Unadjusted basis	Estimated salvage
X	Mar. 15, 1971	$400	$20
Y	June 13, 1971	500	50
Z	July 30, 1971	100	0

The property is eligible property and is properly included in a single vintage account. The asset depreciation range for such property is 5 to 7 years and the taxpayer selects an asset depreciation period of 5½ years and adopts the 200-percent declining balance method of depreciation. The taxpayer adopts the half-year convention described in subparagraph (2) (iii) of this paragraph. After 3 years, A changes from the 200-percent declining balance method to the straight line method of depreciation. Depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	$1,000	0.18182	$181.82	$181.82	$818.18
1972	1,000	.36363	297.52	479.34	520.66
1973	1,000	.36363	189.33	668.67	331.33
1974	1,000	[1].33333	110.44	779.11	220.89
1975	1,000	.33333	110.44	889.56	110.44
1976	1,000	.33333	[2]40.44	930.00	70.00

[1] Rate applied to adjusted basis of the account (without reduction by salvage) at the time as of which the change is made to the straight line method.
[2] The allowable depreciation is limited by estimated salvage.

Example (2). The facts are the same as in example (1) except that A elects to use the modified half-year convention described in subparagraph (2)(ii) of this paragraph. The depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	$1,000	[1]0.36363	$327.27	$327.27	$672.73
1972	1,000	.36363	244.63	571.90	428.10
1973	1,000	.36363	155.67	727.57	272.43
1974	1,000	.33333	90.81	818.38	181.62
1975	1,000	.33333	90.81	909.19	90.81
1976	1,000	.33333	[2]20.81	930.00	70.00

[1] Rate applied to $900, the amount of assets placed in service during the first half of the taxable year.
[2] The allowable depreciation is limited by estimated salvage.

Example (3). The facts are the same as in example (1) except that A adopted the sum of the years-digits method of depreciation and does not change to the straight line method of depreciation. The depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	$1,000	[1] 2.75/18	$152.78	$152.78	$847.22
1972	1,000	5/18	277.78	430.56	569.44
1973	1,000	4/18	222.22	652.78	347.22
1974	1,000	3/18	166.67	819.45	180.55
1975	1,000	2/18	[2] 110.55	930.00	70.00
1976	1,000	1/18	0.00	930.00	70.00
1977	1,000	0.25/18	0.00	930.00	70.00

[1] Rate is equal to one-half of 5.5/18. The denominator is equal to 5.5+4.5+3.5+2.5+1.5+0.5.
[2] The allowable depreciation is limited by estimated salvage.

Example (4). The facts are the same as in example (3) except that A elects to use the modified half-year convention described in subparagraph (2)(ii) of this paragraph. The depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	$1,000	[1] 5.5/18	$275.00	$275.00	$725.00
1972	1,000	5/18	277.78	552.78	447.22
1973	1,000	4/18	222.22	775.00	225.00
1974	1,000	3/18	[2] 155.00	930.00	70.00
1975	1,000	2/18	0.00	930.00	70.00
1976	1,000	1/18	0.00	930.00	70.00
1977	1,000	0.25/18	0.00	930.00	70.00

[1] Rate applied to $900, the amount of assets placed in service during the first half of the taxable year.
[2] The allowable depreciation is limited by estimated salvage.

Example (5). The facts are the same as in example (2) except that after 2 years A changes from the 200-percent declining balance method to the sum of the years-digits method of depreciation. The depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	$1,000	0.36363	$327.27	$327.27	$672.73
1972	1,000	.36363	244.63	571.90	428.10
1973	1,000	4/10	171.24	743.14	256.86
1974	1,000	3/10	128.43	871.57	128.43
1975	1,000	2/10	[1] 58.43	930.00	70.00
1976	1,000	1/10	0.00	930.00	70.00

[1] The allowable depreciation is limited by estimated salvage.

(iv) *Limitation on methods.* (*a*) The same method of depreciation must be adopted for all property in a single vintage account. Generally, the method of depreciation which may be adopted is subject to the limitations contained in section 167(c), (j) and (l).

(*b*) Except as otherwise provided in section 167(j) with respect to certain eligible section 1250 property—

(*1*) In the case of a vintage account for which the taxpayer has selected an asset depreciation period of 3 years or more and which only contains property the original use of which commences with the taxpayer, any method of depreciation described in section 167(b) (1), (2), or (3) may be adopted, but if the vintage account contains property the original use of which does not commence with the taxpayer, or if the asset depreciation period for the account is less than 3 years, a method of depreciation described in section 167(b) (2) or (3) may not be adopted for the account, and

(*2*) The declining balance method using a rate not in excess of 150 per-

cent of the straight line rate based upon the asset depreciation period for the vintage account may be adopted for the account even if the original use of the property does not commence with the taxpayer provided the asset depreciation period for the account is at least 3 years.

(c) The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. (See § 1.167(c)-1).

(v) *Unadjusted and adjusted basis.* (a) For purposes of this section, the unadjusted basis of an asset (including an "excluded addition" and a "property improvement" as described, respectively, in paragraph (d)(2) (vi) and (vii) of this section) is its cost or other basis without any adjustment for depreciation or amortization (other than depreciation under section 179) but with other adjustments required under section 1016 or other applicable provisions of law. The unadjusted basis of a vintage account is the total of the unadjusted bases of all the assets in the account. The unadjusted basis of a "special basis vintage account" as described in paragraph (d)(3)(vi) of this section is the amount of the property improvement determined in paragraph (d)(2)(vii)(a) of this section.

(b) The adjusted basis of a vintage account is the amount by which the unadjusted basis of the account exceeds the reserve for depreciation for the account. The adjusted basis of an asset in a vintage account is the amount by which the unadjusted basis of the asset exceeds the amount of depreciation allowable for the asset under this section computed by using the method of depreciation and the rate applicable to the account. For purposes of this subdivision, the depreciation allowable for an asset shall include, to the extent identifiable, the amount of proceeds previously added to the depreciation reserve in accordance with paragraph (d)(3)(iii) of this section upon the retirement of any portion of such asset. (See paragraph (d)(3)(vi) of this section for election under certain circumstances to allocate adjusted basis of an amount of property improvement determined under paragraph (d)(2)(vii)(a) of this section.)

(2) *Conventions applied to additions and retirements*—(i) *In general.* The allowance for depreciation of a vintage account (whether an item account or a multiple asset account) shall be determined by applying one of the conventions described in subdivisions (ii) and (iii) of this subparagraph. (For the manner of applying a convention in the case of taxable years beginning before and ending after December 31, 1970, see subparagraph (3) of this paragraph.) The same convention must be adopted for all vintage accounts of a taxable year, but the same convention need not be adopted for the vintage accounts of another taxable year. An election to apply this section must specify the convention adopted. (See paragraph (f) of this section for information required in making the election.) The convention adopted by the taxpayer is a method of accounting for purposes of section 446, but the consent of the Commissioner will be deemed granted to make an annual adoption of either of the conventions described in subdivisions (ii) and (iii) of this subparagraph.

(ii) *Modified half-year convention.* The depreciation allowance for a vintage account for which the taxpayer adopts the "modified half-year convention" shall be determined by treating: (a) All property in such account which is placed in service during the first half of the taxable year as placed in service on the first day of the taxable year; and (b) all property in such account which is placed in service during the second half of the taxable year as placed in service on the first day of the succeeding taxable year. The depreciation allowance for a vintage account for a taxable year in which there is an extraordinary retirement (as defined in paragraph (d) (3) (ii) of this section) of property first placed in service during the first half of the taxable year is determined by treating all such retirements from such account during the first half of the taxable year as occurring on the first day of the taxable year and all such retirements from such account during the second half of the taxable year as occurring on the first day of

the second half of the taxable year. The depreciation allowance for a vintage account for a taxable year in which there is an extraordinary retirement (as defined in paragraph (d) (3) (ii) of this section) of property first placed in service during the second half of the taxable year is determined by treating all such retirements from such account during the first half of the taxable year as occurring on the first day of the second half of the taxable year and all such retirements in the second half of the taxable year as occurring on the first day of the succeeding taxable year.

(iii) *Half-year convention.* The depreciation allowance for a vintage account for which the taxpayer adopts the "half-year convention" shall be determined by treating all property in the account as placed in service on the first day of the second half of the taxable year and by treating all extraordinary retirements (as defined in paragraph (d)(3)(ii) of this section) from the account as occurring on the first day of the second half of the taxable year.

(iv) *Rules of application.* (*a*) The first-year convention adopted for a vintage account must be consistently applied to all additions to and all extraordinary retirements from such account. See paragraph (d)(3) (ii) and (iii) of this section for definition and treatment of ordinary retirements.

(*b*) If the actual number of months in a taxable year is other than 12 full calendar months, depreciation is allowed only for such actual number of months and the term "taxable year" for purposes of this subparagraph, shall mean only such number of months. In such event, the first half of such taxable year shall be deemed to expire at the close of the last day of a calendar month which is the closest such last day to the middle of such taxable year and the second half of such taxable year shall be deemed to begin the day after the expiration of the first half of such taxable year. If a taxable year consists of a period which includes only 1 calendar month, the first half of the taxable year shall be deemed to expire on the first day which is nearest to the midpoint of the month, and the second half of the taxable year shall begin the day after the expiration of the first half of the month.

(*c*) For purposes of this subparagraph, for property placed in service after November 14, 1979, other than depreciable property described in paragraph (c)(2)(iv)(*e*) of this section, the taxable year of the person placing such property in service does not include any month before the month in which the person begins engaging in a trade or business or holding depreciable property for the production of income.

(*d*) For purposes of paragraph (c)(2)(iv)(*c*) of this section, an employee is not considered engaged in a trade or business by virtue of employment. In addition, if a person engages in a small amount of trade or business activity for the purpose of obtaining a disproportionately large depreciation deduction for assets for the taxable year in which they are placed in service, and placing those assets in service represents a substantial increase in the person's level of business activity, then for purposes of depreciating those assets the person will not be treated as beginning a trade or business until the increased amount of business activity begins. For property held for the production of income, the principle of the preceding sentence applies.

(*e*) The rules in paragraph (c)(2)(iv) (*c*) and (*d*) of this section do not apply to depreciable property placed in service after November 14, 1979, with respect to which substantial expenditures were paid or incurred prior to November 15, 1979. For purposes of the preceding sentence, expenditures were paid or incurred prior to November 15, 1979. For purposes of the preceding sentence, expenditures will not be considered substantial unless they exceed the lesser of 30 percent of the final cost of the property or $10 million. Expenditures that are not includible in the basis of the depreciable property will be considered expenditures with respect to property if they are directly related to a specific project involving such property. For purposes of determining whether expenditures were paid or incurred prior to November 15, 1979, expenditures made by a person (transferor) other than

the person placing the property in service (transferee) will be taken into account only if the basis of the property in the hands of the transferee is determined in whole or in part by reference to the basis in the hands of the transferor. The principle of the preceding sentence also applies if there are multiple transfers.

(v) *Mass assets.* In the case of mass assets, if extraordinary retirements of such assets in a guideline class during the first half of the taxable year are allocated to a particular vintage year for which the taxpayer applied the modified half-year convention, then that portion of the mass assets so allocated which bears the same ratio to the total number of mass assets so allocated as the mass assets in the same vintage and assets guideline class placed in service during the first half of that vintage year bear to the total mass assets in the same vintage and asset guideline class shall be treated as retired on the first day of the taxable year. The remaining mass assets which are subject to extraordinary retirement during the first half of the taxable year and which are allocated to that vintage year and assets guideline class shall be treated as retired on the first days of the second half of the taxable year. If extraordinary retirements of mass assets in a guideline class occur in the second half of the taxable year and are allocated to a particular vintage year for which the taxpayer applied the modified half-year convention, then that portion of the mass assets so allocated which bears the same ratio to the total number of mass assets so allocated as the mass assets in the same vintage and asset guideline class first placed in service during the first half of that vintage year bear to the total mass assets in the same vintage and asset guideline class shall be treated as retired on the first day of the second half of the taxable year. The remaining mass assets which are subject to extraordinary retirements during the second half of the taxable year and which are allocated to that same vintage and asset guideline class shall be treated as retired on the first day of the succeeding taxable year. If the taxpayer has applied the half-year convention for the vintage year to which the extraordinary retirements are allocated, the mass assets shall be treated as retired on the first day of the second half of the taxable year.

(3) *Taxable years beginning before and ending after December 31, 1970.* In the case of a taxable year which begins before January 1, 1971, and ends after December 31, 1970, property first placed in service after December 31, 1970, but treated as first placed in service before January 1, 1971, by application of a convention described in subparagraph (2) of this paragraph shall be treated as provided in this subparagraph. The depreciation allowed (or allowable) for the taxable year shall consist of the depreciation allowed (or allowable) for the period before January 1, 1971, determined without regard to this section plus the amount allowable for the period after December 31, 1970, determined under this section. However, neither the modified half-year convention described in subparagraph (2)(ii) of this paragraph, nor the half-year convention described in subparagraph (2)(iii) of this paragraph may for any such taxable year be applied with respect to property placed in service after December 31, 1970, to allow depreciation for any period prior to January 1, 1971, unless such convention is consistent with the convention applied by the taxpayer with respect to property placed in service in such taxable year prior to January 1, 1971.

(4) *Examples.* The principles of this paragraph may be illustrated by the following examples:

Example (1).—Taxpayer A, a calendar year taxpayer, places new property in service in a trade or business as follows:

Asset	Placed in service	Unadjusted basis
W	Apr. 1, 1971	$5,000
X	June 30, 1971	8,000
Y	July 15, 1971	12,000

Taxpayer A adopts the modified half-year convention described in subparagraph (2)(ii) of this paragraph. Assets W, X, and Y are placed in a multiple asset account for which the asset depreciation range is 8 to 12 years. A selects 8 years, the minimum asset

depreciation period with respect to such assets, and adopts the declining balance method of depreciation using a rate twice the straight line rate (computed without reduction for salvage). The annual rate under this method using a period of 8 years is 25 percent. The depreciation allowance for assets W and X for 1971 is $3,250, a full year's depreciation under the modified half-year convention (that is, basis of $13,000 (unreduced by salvage) multiplied by 25 percent). The depreciation allowance for asset Y for 1971 is zero under the modified half-year convention.

Example (2). The facts are the same as in example (1), except that the taxpayer adopts the half-year convention described in subparagraph (2) (iii) of this paragraph. The depreciation allowance with respect to asset Y is $1,500 (that is the basis of $12,000 multiplied by 25 percent, then multiplied by ½). Assets W and X are also entitled to a depreciation allowance for only a half year. Thus, the depreciation allowance for assets W and X for 1971 is $1,625 (that is, ½ of the $3,250 allowance computed in example (1)).

Example (3). Asset Z is placed in service by a calendar year taxpayer on December 1, 1971. The taxpayer places asset Z in an item account and adopts the sum of the years-digits method and the half year convention described in subparagraph (2) (iii) of this paragraph. The asset depreciation range for such asset is 4 to 6 years and the taxpayer selects an asset depreciation period of 5 years. The depreciation allowance for asset Z in 1971 is $10,000 (that is, basis of $60,000 (unreduced by salvage) multiplied by 5/15, the appropriate fraction using the sum of the years-digits method then multiplied by ½, since only one half year's depreciation is allowable under the convention).

Example (4).—A is a calendar year taxpayer. All taxpayer A's assets are placed in service in the first half of 1971. If the taxpayer selects the modified half-year convention described in subparagraph (2) (ii) of this paragraph, a full year's depreciation is allowable for all assets.

Example (5).—(i) The taxpayer during his taxable year which begins April 1, 1970, and ends March 31, 1971, places new property in service in a trade or business as follows:

Asset	Placed in service	Unadjusted basis
A	Apr. 30, 1970	$10,000
B	Dec. 15, 1970	10,000
C	Jan. 1, 1971	10,000

The taxpayer adopted a convention under § 1.167(a)-10(b) with respect to assets placed in service prior to January 1, 1971, which treats assets placed in service during the first half of the year as placed in service on the first day of such year and assets placed in service in the second half of the year as placed in service on the first day of the following year. If the taxpayer selects the half-year convention described in subparagraph (2) (iii) of this paragraph, one year's depreciation is allowable on asset A determined without regard to this section. No depreciation is allowable for asset B. No depreciation is allowable for asset C for the period prior to January 1, 1971. One-fourth year's depreciation is allowable on asset C determined under this section.

(ii) The facts are the same as in (i) of this example except that the taxpayer adopts the modified half-year convention described in subparagraph (2) (ii) of this paragraph for 1971. No depreciation is allowable for assets B and C which were placed in service in the second half of the taxable year.

Example (6).—The taxpayer during his taxable year which begins August 1, 1970, and ends July 31, 1971, places new property in service in a trade or business as follows:

Asset	Placed in service
A	Aug. 1, 1970.
B	Jan. 15, 1971.
C	June 30, 1971.

The taxpayer adopted a convention under § 1.167(a)-10(b) with respect to assets placed in service prior to January 1, 1971, which treats all assets as placed in service at the mid-point of the taxable year. If the taxpayer selects the half-year convention described in subparagraph (2) (iii) of this paragraph, one-half year's depreciation is allowable for asset A determined without regard to this section. One-half year's depreciation is allowable for assets B and C determined under this section.

Example (7). X, a calendar year corporation, is incorporated on July 1, 1978, and begins engaging in a trade or business in September 1979. X purchases asset A and places it in service on November 20, 1979. Substantial expenditures were not paid or incurred by X with respect to asset A prior to November 15, 1979. For purposes of applying the conventions under this section to determine depreciation for asset A, the 1979 taxable year is treated as consisting of 4 months. The first half of the taxable year ends on October 31, 1979, and the second half begins on November 1, 1979. X adopts the half-year convention. Asset A is treated as placed in service on November 1, 1979.

Example (8). On January 20, 1982, A, B, and C enter an agreement to form partnership P for the purpose of purchasing and leasing a ship to a third party, Z. P uses the calendar year as its taxable year. On De-

cember 15, 1982, P acquires the ship and leases it to Z. For purposes of applying the conventions, P begins its leasing business in December 1982, and its taxable year begins on December 1, 1982. Assuming that P elects to apply this section and adopts the modified half-year convention, P depreciates the ship placed in service in 1982 for the 1-month period beginning December 1, 1982, and ending December 31, 1982.

Example (9). A and B form partnership P on December 15, 1981, to conduct a business of leasing small aircraft. P uses the calendar year as its taxable year. On January 15, 1982, P acquires and places in service a $25,000 aircraft. P begins engaging in business with only one aircraft for the purpose of obtaining a disproportionately large depreciation deduction for aircraft that P plans to acquire at the end of the year. On December 10, 1982, P acquires and places in service 4 aircraft, the total purchase price of which is $250,000. For purposes of applying the conventions to the aircraft acquired in December, P begins its leasing business in December 1982, and P's taxable year begins December 1, 1982, and ends December 31, 1982. Assuming that P elects to apply this section and adopts the modified half-year convention, P depreciates the aircraft placed in service in December 1982, for the 1-month period beginning December 1, 1982, and ending December 31, 1982. P depreciates the aircraft placed in service in January 1982, for the 12-month period beginning January 1, 1982, and ending December 31, 1982.

(d) *Special rules for salvage, repairs and retirements*—(1) *Salvage value*—(i) *Definition of gross salvage value.* "Gross salvage" value is the amount which is estimated will be realized upon a sale or other disposition of the property in the vintage account when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service, without reduction for the cost of removal, dismantling, demolition or similar operations. If a taxpayer customarily sells or otherwise disposes of property at a time when such property is still in good operating condition, the gross salvage value of such property is the amount expected to be realized upon such sale or disposition, and under certain circumstances, as where such property is customarily sold at a time when it is still relatively new, the gross salvage value may constitute a relatively large proportion of the unadjusted basis of such property.

(ii) *Definition of salvage value.* "Salvage value" means gross salvage value less the amount, if any, by which the gross salvage value is reduced by application of section 167(f). Generally, as provided in section 167(f), a taxpayer may reduce the amount of gross salvage value of a vintage account by an amount which does not exceed 10 percent of the unadjusted basis of the personal property (as defined in section 167(f)(2)) in the account. See paragraph (b)(3)(ii) of this section for requirement of separate vintage accounts for personal property described in section 167(f)(2).

(iii) *Estimation of salvage value.* The salvage value of each vintage account of the taxable year shall be estimated by the taxpayer at the time the election to apply this section is made, upon the basis of all the facts and circumstances existing at the close of the taxable year in which the account is established. The taxpayer shall specify the amount, if any, by which gross salvage value taken into account is reduced by application of section 167(f). See paragraph (f)(2) of this section for requirement that the election specify the estimated salvage value for each vintage account of the taxable year of election. The salvage value estimated by the taxpayer will not be redetermined merely as a result of fluctuations in price levels or as a result of other facts and circumstances occurring after the close of the taxable year of election. Salvage value for a vintage account need not be established or increased as a result of a property improvement as described in subparagraph (2) (vii) of this paragraph. The taxpayer shall maintain records reasonably sufficient to determine facts and circumstances taken into account in estimating salvage value.

(iv) *Salvage as limitation on depreciation.* In no case may a vintage account be depreciated below a reasonable salvage value after taking into account any reduction in gross salvage value permitted by section 167(f).

(v) *Limitation on adjustment of reasonable salvage value.* The salvage value established by the taxpayer for a vintage account will not be redetermined if it is reasonable. Since the determination of salvage value is a

matter of estimation, minimal adjustments will not be made. The salvage value established by the taxpayer will be deemed to be reasonable unless there is sufficient basis in the facts and circumstances existing at the close of the taxable year in which the account is established for a determination of an amount of salvage value for the account which exceeds the salvage value established by the taxpayer for the account by an amount greater than 10 percent of the unadjusted basis of the account at the close of the taxable year in which the account is established. If the salvage value established by the taxpayer for the account is not within the 10 percent range, or if the taxpayer follows the practice of understating his estimates of gross salvage value to take advantage of this subdivision, and if there is a determination of an amount of salvage value for the account which exceeds the salvage value established by the taxpayer for the account, an adjustment will be made by increasing the salvage value established by the taxpayer for the account by an amount equal to the difference between the salvage value as determined and the salvage value established by the taxpayer for the account. For the purposes of this subdivision, a determination of salvage value shall include all determinations at all levels of audit and appellate proceedings, and as well as all final determinations within the meaning of section 1313(a) (1). This subdivision shall apply to each such determination. (See example (3) of subdivision (vi) of this subparagraph.)

(vi) *Examples.* The principles of this subparagraph may be illustrated by the following examples in which it is assumed that the taxpayer has not followed a practice of understating his estimates of gross salvage value:

Example (1). Taxpayer B elects to apply this section to assets Y and Z, which are placed in a multiple asset vintage account of 1971 for which the taxpayer selects an asset depreciation period of 8 years. The unadjusted basis of asset Y is $50,000 and the unadjusted basis of asset Z is $30,000. B estimates a gross salvage value of $55,000. The property qualifies under section 167(f) (2) and B reduces the amount of salvage taken into account by $8,000 (that is, 10 percent of $80,000 under section 167(f)). Thus, B establishes a salvage value of $47,000 for the account. Assume that there is not sufficient basis for determining a salvage value for the account greater than $52,000 (that is, $60,000 minus the $8,000 reduction under section 167(f)). Since the salvage value of $47,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage value for the account will not be redetermined.

Example (2). The facts are the same as in example (1) except that B estimates a gross salvage value of $50,000 and establishes a salvage value of $42,000 for the account (that is, $50,000 minus the $8,000 reduction under section 167(f)). There is sufficient basis for determining an amount of salvage value greater than $50,000 (that is, $58,000 minus the $8,000 reduction under section 167(f)). The salvage value of $42,000 established by B for the account can be redetermined without regard to the limitation in subdivision (v) of this subparagraph, since it is not within the 10 percent range. Upon audit of B's tax return for a taxable year for which the redetermination would affect the amount of depreciation allowable for the account, salvage value is determined to be $52,000 after taking into account the reduction under section 167(f). Salvage value for the account will be adjusted to $52,000.

Example (3). The facts are the same as in example (1) except that upon audit of B's tax return for a taxable year the examining officer determines the salvage value to be $58,000 (that is, $66,000 minus the $8,000 reduction under section 167(f)), and proposes to adjust salvage value for the vintage account to $58,000 which will result in disallowing an amount of depreciation for the taxable year. B does not agree with the finding of the examining officer. After receipt of a "30-day letter", B waives a district conference and initiates proceedings before the Appellate Division. In consideration of the case by the Appellate Division it is concluded that there is not sufficient basis for determining an amount of salvage value for the account in excess of $55,000 (that is $63,000 minus the $8,000 reduction under section 167(f)). Since the salvage of $47,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage value for the account will not be redetermined.

Example (4). Taxpayer C elects to apply this section to factory building X which is placed in an item vintage account of 1971. The unadjusted basis of factory building X is $90,000. C estimates a gross salvage value for the account of $10,000. The property does not qualify under section 167(f)(2). C establishes a salvage value of $10,000 for the account. Assume that there is not sufficient basis for determining a salvage value for the account greater than $18,000. Since the sal-

vage value of $10,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage value for the account will not be redetermined.

(2) *Treatment of repairs*—(i) *In general.* (*a*) Sections 162, 212, and 263 provide general rules for the treatment of certain expenditures for the repair, maintenance, rehabilitation or improvement of property. In general, under those sections, expenditures which substantially prolong the life of an asset, or are made to increase its value or adapt it to a different use are capital expenditures. If an expenditure is treated as a capital expenditure under section 162, 212, or 263, it is subject to the allowance for depreciation. On the other hand, in general, expenditures which do not substantially prolong the life of an asset or materially increase its value or adapt it for a substantially different use may be deducted as an expense in the taxable year in which paid or incurred. Expenditures, or a series of expenditures, may have characteristics both of deductible expenses and capital expenditures. Other expenditures may have the characteristics of capital expenditures, as in the case of an "[illegible]luded addition" (as defined in s[illegible]vision (vi) of this subparagraph). This subparagraph provides a simplified procedure for determining whether expenditures with respect to certain property are to be treated as deductible expenses or capital expenditures.

(*b*) [Reserved]

(ii) *Election of repair allowance.* In the case of an asset guideline class which consists of "repair allowance property" as defined in subdivision (iii) of this subparagraph, subject to the provisions of subdivision (v) of this subparagraph, the taxpayer may elect to apply the asset guideline class repair allowance described in subdivision (iii) of this subparagraph for any taxable year ending after December 31, 1970, for which the taxpayer elects to apply this section.

(iii) *Repair allowance for an asset guideline class.* For a taxable year for which the taxpayer elects to apply this section, the "repair allowance" for an asset guideline class which consists of "repair allowance property" is an amount equal to—

(*a*) The average of (*1*) the unadjusted basis of all "repair allowance property" in the asset guideline class at the beginning of the taxable year, less in the case of such property in a vintage account the unadjusted basis of all such property retired in an ordinary retirement (as described in subparagraph (3)(ii) of this paragraph) in prior taxable years, and (*2*) the unadjusted basis of all "repair allowance property" in the asset guideline class at the end of the taxable year, less in the case of such property in a vintage account the unadjusted basis of all such property retired in an ordinary retirement (including ordinary retirements during the taxable year), multiplied by—

(*b*) The repair allowance percentage in effect for the asset guideline class for the taxable year.

In applying the assets guideline class repair allowance to buildings which are section 1250 property, for the purpose of this subparagraph each building shall be treated as in a separate asset guideline class. If two or more buildings are in the same asset guideline class determined without regard to the preceding sentence and are operated as an integrated unit (as evidenced by their actual operation, management, financing and accounting), they shall be treated as a single building for this purpose. The "repair allowance percentages" in effect for taxable years ending before the effective date of the first supplemental repair allowance percentages established pursuant to this section are set forth in Revenue Procedure 72-10. Repair allowance percentages will from time to time be established, supplemented and revised with express reference to this section. These repair allowance percentages will be published in the Internal Revenue Bulletin. The repair allowance percentages in effect on the last day of the taxable year shall apply for the taxable year, except that the repair allowance percentage for a particular taxable year shall not be less than the repair allowance percentage in effect on the first day of such taxable year (or as of such later time in such year as a repair allowance percentage first established during such

year becomes effective). Generally, the repair allowance percentages for a taxable year shall not be changed to reflect any supplement or revision of the repair allowance percentages after the end of such taxable year. However, if expressly provided in such a supplement or revision of the repair allowance percentages, the taxpayer may, at his option in the manner specified therein, apply the revised or supplemented repair allowance percentages for such taxable year and succeeding taxable years. For the purposes of this section, "repair allowance property" means eligible property determined without regard to paragraph (b)(2)(ii) of this section (that is, without regard to whether such property was first placed in service by the taxpayer before or after December 31, 1970) in an asset guideline class for which a repair allowance percentage is in effect for the taxable year. The determination whether property is repair allowance property shall be made without regard to whether such property is excluded, under paragraph (b)(5) of this section, from an election to apply this section. Property in an asset guideline class for which the taxpayer elects to apply the asset guideline class repair allowance described in this subdivision, which results from expenditures in the taxable year of election for the repair, maintenance, rehabilitation, or improvement of property in an asset guideline class shall not be "repair allowance property" for such taxable year but shall be for each succeeding taxable year provided such property is a property improvement as described in subdivision (vii) (*a*) of this subparagraph and is in an asset guideline class for which a repair allowance percentage is in effect for such succeeding taxable year.

(iv) *Application of asset guideline class repair allowance.* In accordance with the principles of sections 162, 212, and 263, if the taxpayer pays or incurs any expenditures during the taxable year for the repair, maintenance, rehabilitation or improvement of eligible property (determined without regard to paragraph (b)(2)(ii) of this section), the taxpayer must either—

(*a*) If such property is repair allowance property and if the taxpayer elects to apply the repair allowance for the asset guideline class, treat an amount of all such expenditures in such taxable year with respect to all such property in the asset guideline class which does not exceed in total the repair allowance for that asset guideline class as deductible repairs, and treat the excess of all such expenditures with respect to all such property in the asset guideline class in the manner described for a property improvement in subdivision (viii) of this subparagraph, or

(*b*) If such property is not repair allowance property or if the taxpayer does not elect to apply the repair allowance for the asset guideline class, treat each of such expenditures in such taxable year with respect to all such property in the asset guideline class as either a capital expenditure or as a deductible repair in accordance with the principles of sections 162, 212, and 263 (without regard to (*a*) of this subdivision), and treat the expenditures which are required to be capitalized under sections 162, 212, and 263 (without regard to (*a*) of this subdivision) in the manner described for a property improvement in subdivision (viii) of this subparagraph.

For the purposes of (*a*) of this subdivision, expenditures for the repair, maintenance, rehabilitation or improvement of property do not include expenditures for an excluded addition or for which a deduction is allowed under section 167(k). (See subdivision (viii) of this subparagraph for treatment of an excluded addition.) The taxpayer shall elect each taxable year whether to apply the repair allowance and treat expenditures under (*a*) of this subdivision, or to treat expenditures under (*b*) of this subdivision. The treatment of expenditures under this subdivision for a taxable year for all asset guideline classes shall be specified in the books and records of the taxpayer for the taxable year. The taxpayer may treat expenditures under (*a*) of this subdivision with respect to property in one asset guideline class and treat expenditures under (*b*) of this subdivision with respect to

property in some other asset guideline class. In addition, the taxpayer may treat expenditures with respect to property in an asset guideline class under (*a*) of this subdivision in one taxable year, and treat expenditures with respect to property in that asset guideline class under (*b*) of this subdivision in another taxable year.

(v) *Special rules for repair allowance.* (*a*) The asset guideline class repair allowance described in subdivision (iii) of this subparagraph shall apply only to expenditures for the repair, maintenance, rehabilitation or improvement of repair allowance property (as described in subdivision (iii) of this subparagraph). The taxpayer may apply the asset guideline class repair allowance for the taxable year only if he maintains books and records reasonably sufficient to determine:

(*1*) The amount of expenditures paid or incurred during the taxable year for the repair, maintenance, rehabilitation or improvement of repair allowance property in the asset guideline class, and

(*2*) The expenditures (and the amount thereof) with respect to such property which are for excluded additions (such as whether the expenditure is for an additional identifiable unit of property, or substantially increases the productivity or capacity of an existing identifiable unit of property or adapts it for a substantially different use).

In general, such books and records shall be sufficient to identify the amount and nature of expenditures with respect to specific items of repair allowance property or groups of similar properties in the same asset guideline class. However, in the case of such expenditures with respect to property, part of which is in one asset guideline class and part in another, or part of which is repair allowance property and part of which is not, and in comparable circumstances involving property in the same asset guideline class, to the extent books and records are not maintained identifying such expenditures with specific items of property or groups of similar properties and it is not practicable to do so, the total amount of such expenditures which is not specifically identified may be allocated by any reasonable method consistently applied. In any case, the cost of repair, maintenance, rehabilitation or improvement of property performed by production personnel may be allocated by any reasonable method consistently applied and if performed incidental to production and not substantial in amount, no allocation to repair, maintenance, rehabilitation or improvement need be made. The types of expenditures for which specific identification would ordinarily be made include: Substantial expenditures such as for major parts or major structural materials for which a work order is or would customarily be written; expenditures for work performed by an outside contractor; or expenditures under a specific down time program. Types of expenditures for which specific identification would ordinarily be impractical include: General maintenance costs of machinery, equipment, and plant in the case of a taxpayer having assets in more than one class (or different types of assets in the same class) which are located together and generally maintained by the same work crew; small supplies which are used with respect to various classes or types of property; labor costs of personnel who work on property in different classes, or different types of property in the same class, if the work is performed on a routine, as needed, basis and the only identification of the property repaired is by the personnel. Factors which will be taken into account in determining the reasonableness of the taxpayer's allocation of expenditures include prior experience of the taxpayer; relative bases of the assets in the guideline class; types of assets involved; and relationship to specifically identified expenditures.

(*b*) If for the taxable year the taxpayer elects to deduct under section 263(e) expenditures with respect to repair allowance property consisting of railroad rolling stock (other than a locomotive) in a particular asset guideline class, the taxpayer may not, for such taxable year, use the asset guideline class repair allowance described in subdivision (iii) of this subparagraph for any property in such asset guideline class.

(c)(1) If the taxpayer repairs, rehabilitates or improves property for sale or resale to customers, the asset guideline class repair allowance described in subdivision (iii) of this subparagraph shall not apply to expenditures for the repair, maintenance, rehabilitation or improvement of such property, or (2) if a taxpayer follows the practice of acquiring for his own use property (in need of repair, rehabilitation or improvement to be suitable for the use intended by the taxpayer) and of making expenditures to repair, rehabilitate or improve such property in order to take advantage of this subparagraph, the asset guideline class repair allowance described in subdivision (iii) of this subparagraph shall not apply to such expenditures. In either event, such property shall not be "repair allowance property" as described in subdivision (iii) of this subparagraph.

(vi) *Definition of excluded addition.* The term "excluded addition" means—

(a) An expenditure which substantially increases the productivity of an existing identifiable unit of property over its productivity when first acquired by the taxpayer;

(b) An expenditure which substantially increases the capacity of an existing identifiable unit of property over its capacity when first acquired by the taxpayer;

(c) An expenditure which modifies an existing identifiable unit of property for a substantially different use;

(d) An expenditure for an identifiable unit of property if (1) such expenditure is for an additional identifiable unit of property or (2) such expenditure (other than an expenditure described in (e) of this subdivision) is for replacement of an identifiable unit of property which was retired;

(e) An expenditure for replacement of a part in or a component or portion of an existing identifiable unit of property (whether or not such part, component or portion is also an identifiable unit of property) if such part, component or portion is for replacement of a part, component or portion which was retired in a retirement upon which gain or loss is recognized (or would be recognized but for a special nonrecognition provision of the Code or § 1.1502-13).

(f) In the case of a building or other structure (in addition to (b), (c), (d), and (e) of this subdivision which also apply to such property), an expenditure for additional cubic or linear space; and

(g) In the case of those units of property of pipelines, electric utilities, telephone companies, and telegraph companies consisting of lines, cables and poles (in addition to (a) through (e) of this subdivision which also apply to such property), an expenditure for replacement of a material portion of the unit of property.

Except as provided in (d) and (e) of this subdivision, notwithstanding any other provision of this subdivision, the term "excluded addition" does not include any expenditure in connection with the repair, maintenance, rehabilitation or improvement of an identifiable unit of property which does not exceed $100. For this purpose all related expenditures with respect to the unit of property shall be treated as a single expenditure. For the purposes of (a), and (b) of this subdivision, an increase in productivity or capacity is substantial only if the increase is more than 25 percent. An expenditure which merely extends the productive life of an identifiable unit of property is not an increase in productivity within the meaning of (a) of this subdivision. Under (g) of this subdivision a replacement is material only if the portion replaced exceeds 5 percent of the unit of property with respect to which the replacement is made. For the purposes of this subdivision, a unit of property generally consists of each operating unit (that is, each separate machine or piece of equipment) which performs a discrete function and which the taxpayer customarily acquires for original installation and retires as a unit. The taxpayer's accounting classification of units of property will generally be accepted for purposes of this subdivision provided the classifications are reasonably consistent with the preceding sentence and are consistently applied. In the case of a building the unit of property generally consists of the building as well as its structural components; except that each building service system (such as

an elevator, an escalator, the electrical system, or the heating and cooling system) is an identifiable unit for the purpose of (*a*), (*b*), (*c*), and (*d*) of this subdivision. However, both in the case of machinery and equipment and in the case of a building, for the purpose of applying (*d*)(*1*) of this subdivision a unit of property may consist of a part in or a component or portion of a larger unit of property. In the case of property described in (*g*) of this subdivision (such as a pipeline), a unit of property generally consists of each segment which performs a discrete function either as to capacity, service, transmission or distribution between identifiable points. Thus, for example, under this subdivision in the case of a vintage account of five automobiles each automobile is an identifiable unit of property (which is not merely a part in or a component or portion of larger unit of property within the meaning of (*e*) of this subdivision). Accordingly, the replacement of one of the automobiles (which is retired) with another automobile is an excluded addition under (*d*)(*2*) of this subdivision. Also the purchase of a sixth automobile is an expenditure for an additional identifiable unit of property and is an excluded addition under (*d*)(*1*) of this subdivision. An automobile air conditioner is also an identifiable unit of property for the purposes of (*d*)(*1*) of this subdivision, but not for the purposes of (*d*)(*2*) of this subdivision. Accordingly, the addition of an air conditioner to an automobile is an excluded addition under (*d*)(*1*) of this subdivision, but the replacement of an existing air conditioner in an automobile is not an excluded addition under (*d*)(*2*) of this subdivision (since it is merely the replacement of a part in an existing identifiable unit of property). The replacement of the air conditioner may, however, be an excluded addition under (*e*) of this subdivision, if the air conditioner replaced was retired in a retirement upon which gain or loss was recognized. The principles of this subdivision may be further illustrated by the following examples in which it is assumed (unless otherwise stated) that (*e*) of this subdivision does not apply:

Example (*1*). For the taxable year, B pays or incurs only the following expenditures: (*1*) $5,000 for general maintenance of repair allowance property (as described in subdivision (iii) of this subparagraph) such as inspection, oiling, machine adjustments, cleaning, and painting; (*2*) $175 for replacement of bearings and gears in an existing lathe; (*3*) $125 for replacement of an electric starter (of the same capacity) and certain electrical wiring in an automatic drill press; (*4*) $300 for modification of a metal fabricating machine (including replacement of certain parts) which substantially increases its capacity; (*5*) $175 for repair of the same metal fabricating machine which does not substantially increase its capacity; (*6*) $800 for the replacement of an existing lathe with a new lathe; and (*7*) $65 for the repair of a drill press. Expenditures (*1*) through (*3*) are expenditures for the repair, maintenance, rehabilitation or improvement of property to which B can elect to apply the asset guideline class repair allowance described in subdivision (iii) of this subparagraph. Expenditure (*4*) is an excluded addition under (*b*) of this subdivision. Expenditure (*5*) is not an excluded addition. Expenditure (*6*) is an excluded addition under (*d*)(*2*) of this subdivision. Without regard to (*a*), (*b*), and (*c*) of this subdivision, expenditure (7) is not an excluded addition since the expenditure does not exceed $100.

Example (*2*). Corporation M operates a steel plant which produces rails, blooms, billets, special bar sections, reinforcing bars, and large diameter line pipe. During the taxable year, corporation M: (*1*) relines an openhearth furnace; (*2*) places in service 20 new ingot molds; (*3*) replaces one reversing roll in the blooming mill; (*4*) overhauls the rail and billet mill with no increase in capacity; (*5*) replaces a roll stand in the 20-inch bar mill; and (*6*) overhauls the 11-inch bar mill and reducing stands increasing billet speed from 1,800 feet per minute to 2,300 feet per minute. Assume that each expenditure exceeds $100. Expenditure (*1*) is not an excluded addition. Expenditure (*2*) is an excluded addition under (*d*)(*1*) of this subdivision. Expenditure (*3*) is not an excluded addition since the expenditure for the reversing roll merely replaces a part in an existing identifiable unit of property. Expenditure (*4*) is not an excluded addition. Expenditure (*5*) is an excluded addition under (*d*)(*2*) of this subdivision since the roll stand is not merely a part of an existing identifiable unit of property. Expenditure (*6*) is an excluded addition under (*a*) of this subdivision since it increases the billet speed by more than 25 percent.

Example (*3*). For the taxable year, corporation X pays or incurs the following expenditures: (*1*) $1,000 for two new temporary partition walls in the company's of-

fices; (2) $1,400 for repainting the exterior of a terminal building; (3) $300 for repair of the roof of a warehouse; (4) $150 for replacement of two window frames and panes in the warehouse; and (5) $100 for plumbing repair. Expenditure (1) is an excluded addition under (d)(1) of this subdivision. None of the other expenditures are excluded additions.

Example (4). For the taxable year, corporation Y pays or incurs the following expenditures: (1) $10,000 for expansion of a loading dock from 600 square feet to 750 square feet; (2) $600 for replacement of two roof girders in a factory building; and (3) $9,500 for replacement of columns and girders supporting the floor of a second story loft storage area within the factory building in order to permit storage of supplies with a gross weight 50 percent greater than the previous capacity of the loft. Expenditure (1) is an excluded addition under (f) of this subdivision. Expenditure (2) is not an excluded addition. Expenditure (3) is an excluded addition under (b) of this subdivision.

Example (5). Corporation A has an office building with an unadjusted basis of $10 million. The building has 10 elevators, five of which are manually operated and five of which are automatic. During 1971, corporation A:

(1) Replaces the five manually operated elevators with highspeed automatic elevators at a cost of $400,000;

(2) Replaces the cable in one of the existing automatic elevators at a cost of $1,700. The replacements of the elevators are excluded additions under (d)(2) of this subdivision. The replacement of the cable is not an excluded addition.

Example (6). Taxpayer W, a cement manufacturer, engages in the following modification and maintenance activities during the taxable year: (1) Replaces eccentric-bearing, spindle, and wearing surface in a gyratory crusher; (2) places in service a new apron feeder and hammer mill; (3) replaces four buckets on a chain bucket elevator; (4) relines refractory surface in the burning zone of a rotary kiln; (5) installs additional new dust collectors; and (6) Replaces two 16-inch × 90-foot belts on his conveyer system. Assume that there is no increase in productivity or capacity and that each expenditure exceeds $100. Expenditure (1) is not an excluded addition. Expenditure (2) an excluded addition under (d)(1) of this subdivision. Expenditures (3) and (4) are not excluded additions. Expenditures (5) is an excluded addition under (d)(1) of this subdivision. Expenditure (6) is not an excluded addition.

Example (7). Corporation X, a gas pipeline company, has, in addition to others, the following units of property: (1) A gathering pipeline for a field consisting of 25 gas wells; (2) the main transmission line between compressor stations (that is, in the case of a 500-mile main transmission line with a compressor station every 100 miles, each one hundred miles section between compressor stations is a separate unit of property); (3) a lateral transmission line from the main transmission line to a city border station; (4) a medium pressure distribution line to the northern portion of the city; and (5) a low pressure distribution line serving a group of approximately 200 residential customers off the medium pressure distribution line. In 1971, corporation X pays or incurs the following expenditures in connection with the repair, maintenance, rehabilitation or improvement of repair allowance property: (1) replaces a meter on a gas well; (2) in connection with the repair and rehabilitation of a unit of property consisting of a 2-mile gathering pipeline, replaces a 3,000-foot section of the gathering line; (3) in connection with the repair of leaks in a unit of property consisting of a 100-mile gas transmission line (that is, the 100 miles between compressor stations), replaces a 2,000-foot section of pipeline at one point; and (4) at another point replaces a 7-mile section of the same 100-mile gas transmission line. Assume that none of these expenditures substantially increases capacity and that each expenditure exceeds $100. Expenditure (1) is an excluded addition under (d) of this subdivision. Expenditure (2) is an excluded addition under (g) of this subdivision since the portion replaced is more than 5 percent of the unit of property. Expenditure (3) is not an excluded addition. Expenditure (4) is an excluded addition under (g) of this subdivision.

Example (8). Taxpayer Y, an electric utility company, has in addition to others, the following units of property: (1) A high voltage transmission circuit from the switching station (at the generating station) to the transmission station; (2) a series of 100 poles (fully dressed) supporting the circuit in (1); (3) a high voltage circuit from the transmission station to the distribution substation; (4) a high voltage distribution circuit (either radial or looped) from the distribution substation; (5) a transformer on a distribution pole; (6) a circuit breaker on a distribution pole; and (7) all 220 (and lower) volt circuit (including customer service connections) off the distribution circuit in (4). In 1971, taxpayer Y pays or incurs the following expenditures for the repair, maintenance, rehabilitation or improvement of repair allowance property: (1) Replaces 25 adjacent poles in a unit of property consisting of the 300 poles supporting a radial distribution circuit from a distribution substation; (2) replaces a transformer on one of the poles in (1); (3) replaces a cross-arm on one of the poles in (1); (4) replaces a 200-foot section of a 2-mile radial distribution circuit serving

100 residential customers; and (5) replaces a 2,000-foot section on a 10-mile high voltage circuit from a transmission station to a distribution substation which was destroyed by a casualty which taxpayer Y treated as an extraordinary retirement under paragraph (d)(3)(ii) of this section. Expenditure (1) is an excluded addition under (g) of this subdivision. Expenditure (2) is an excluded addition under (d)(2) of this subdivision. Expenditures (3) and (4) are not excluded additions. Expenditure (5) is an excluded addition under (e) of this subdivision.

Example (9). Corporation Z, a telephone company, has in addition to others, the following units of property: (1) A buried feeder cable 3 miles in length off a local switching station; (2) a buried subfeeder cable 1 mile in length off the feeder cable in (1); (3) all the distribution cable (and customer service drops) off the subfeeder cable in (2); (4) the 300 poles (fully dressed) supporting the distribution cable in (3); (5) a 10-mile local trunk cable which interconnects two local tandem switching stations; (6) a toll connecting trunk cable from a local tandem switching station to a long distance tandem switching station; (7) a toll trunk cable 50 miles in length from the access point at one city to the access point at another city. In 1971, corporation Z pays or incurs the following expenditures in connection with the repair, maintenance, rehabilitation or improvement of repair allowance property: (1) replaces 100 feet of distribution cable in a unit of property consisting of 8 miles of local distribution cable (plus customer service drops); (2) replaces an amplifier in the distribution system; and (3) replaces 10 miles of a unit of property consisting of a toll trunk cable 50 miles in length. Expenditure (1) is not an excluded addition. Expenditure (2) is an excluded addition under (d)(2) of this subdivision. Expenditure (3) is an excluded addition under (g) of this subdivision.

(vii) *Definition of property improvement.* The term "property improvement" means—

(a) If the taxpayer treats expenditures for the asset guideline class under subdivision (iv) (a) of this subparagraph, the amount of all expenditures paid or incurred during the taxable year for the repair, maintenance, rehabilitation or improvement of repair allowance property in the asset guideline class, which exceeds the asset guideline class repair allowance for the taxable year; and

(b) If the taxpayer treats expenditures for the asset guideline class under subdivision (iv) (b) of this subparagraph, the amount of each expenditure paid or incurred during the taxable year for the repair, maintenance, rehabilitation or improvement of property which is treated under sections 162, 212, and 263 as a capital expenditure.

The term "property improvement" does not include any expenditure for an excluded addition.

(viii) *Treatment of property improvements and excluded additions.* If for the taxable year there is a property improvement as described in subdivision (vii) of this subparagraph or an excluded addition as described in subdivision (vi) of this subparagraph, the following rules shall apply—

(a) The total amount of any property improvement for the asset guideline class determined under subdivision (vii)(a) of this subparagraph shall be capitalized in a single "special basis vintage account" of the taxable year in accordance with the taxpayer's election to apply this section for the taxable year (applied without regard to paragraph (b)(5)(v)(a) of this section). See subparagraph (3)(vi) of this paragraph for definition and treatment of a "special basis vintage account".

(b) Each property improvement determined under subdivision (vii)(b) of this subparagraph, if it is eligible property, shall be capitalized in a vintage account of the taxable year in accordance with the taxpayer's election to apply this section for the taxable year (applied without regard to paragraph (b)(5)(v)(a) of this section).

(c) Each excluded addition, if it is eligible property, shall be capitalized in a vintage account of the taxable year in accordance with the taxpayer's election to apply this section for the taxable year.

For rule as to date on which a property improvement or an excluded addition is first placed in service, see paragraph (e)(1) (iii) and (iv) of this section.

(ix) *Examples.* The principles of this subparagraph may be illustrated by the following examples:

Example (1). For the taxable year 1972, B elects to apply this section. B has repair allowance property (as described in subdivision (iii) of this subparagraph) in asset guideline class 20.2 under Revenue Proce-

dure 72-10 with an average unadjusted basis determined as provided in subdivision (iii) (*a*) of this subparagraph of $100,000 and repair allowance property in asset guideline class 24.4 with an average unadjusted basis of $300,000. The repair allowance percentage for asset guideline class 20.2 is 4.5 percent and for asset guideline class 24.4 is 6.5 percent. The two asset guideline class repair allowances for 1972 are $4,500 and $19,500, respectively, determined as follows:

Asset Guideline Class 20.2	
$100,000 average unadjusted basis multiplied by 4.5 percent	$4,500
Asset Guideline Class 24.4	
$300,000 average unadjusted basis multiplied by 6.5 percent	$19,500

Example (2). The facts are the same as in example (1). During the taxable year 1972, B pays or incurs the following expenditures for the repair, maintenance, rehabilitation or improvement of repair allowance property in asset guideline class 20.2

General maintenance (including primarily labor costs)	$3,000
Replacement of parts in several machines (including labor costs of $1,650)	4,000
	7,000

In addition, in connection with the rehabilitation and improvement of two other machines B pays or incurs $6,000 (including labor costs of $2,000) which is treated as an excluded addition because the capacity of the machines was substantially increased. For 1972, B elects to apply this section and to apply the asset guideline class repair allowance to asset guideline class 20.2. Since the asset guideline class repair allowance is $4,500, B can deduct $4,500 in accordance with subdivision (iv) (*a*) of this subparagraph. B must capitalize $2,500 in a special basis vintage account in accordance with subdivisions (vii) (*a*) and (viii) (*a*) of this subparagraph. Since the excluded addition is a capital item and is eligible property, B must also capitalize $6,000 in a vintage account in accordance with subdivision (viii) (*c*) of this subparagraph. B selects from the asset depreciation range an asset depreciation period of 17 years for the special basis vintage account. B includes the excluded addition in a vintage account of 1972 for which he also selects an asset depreciation period of 17 years.

(3) *Treatment of retirements*—(i) *In general.* The rules of this subparagraph specify the treatment of all retirements from vintage accounts. The rules of § 1.167(a)-8 shall not apply to any retirement from a vintage account. An asset in a vintage account is retired when such asset is permanently withdrawn from use in a trade or business or in the production of income by the taxpayer. A retirement may occur as a result of a sale or exchange, by other act of the taxpayer amounting to a permanent disposition of an asset, or by physical abandonment of an asset. A retirement may also occur by transfer of an asset to supplies or scrap.

(ii) *Definitions of ordinary and extraordinary retirements.* The term "ordinary retirement" means any retirement of section 1245 property from a vintage account which is not treated as an "extraordinary retirement" under this subparagraph. The retirement of an asset from a vintage account in a taxable year is an "extraordinary retirement" if—

(*a*) The asset is section 1250 property;

(*b*) The asset is section 1245 property which is retired as the direct result of fire, storm, shipwreck, or other casualty and the taxpayer, at his option consistently applied (taking into account type, frequency, and the size of such casualties) treats such retirements as extraordinary; or

(*c*)(*1*) The asset is section 1245 property which is retired (other than by transfer to supplies or scrap) in a taxable year as the direct result of a cessation, termination, curtailment, or disposition of a business, manufacturing, or other income producing process, operation, facility or unit, and (2) the unadjusted basis (determined without regard to subdivision (vi) of this subparagraph) of all such assets so retired in such taxable year from such account as a direct result of the event described in (*c*)(*1*) of this subdivision exceeds 20 percent of the unadjusted basis of such account immediately prior to such event.

For the purposes of (*c*) of this subdivision, all accounts (other than a special basis vintage account as described in subdivision (vi) of this subparagraph) containing section 1245 property of the same vintage in the same asset guideline class, and from which a retirement as a direct result of such

event occurs within the taxable year, shall be treated as a single vintage account. See subdivision (xi) of this subparagraph for special rule for item accounts. The principles of this subdivision may be illustrated by the following examples:

Example (1). Taxpayer A is a processor and distributor of dairy products. Part of taxpayer A's operation is a bottle washing facility consisting of machines X, Y, and Z, each of which is in an item vintage account of 1971. Each item vintage account has an unadjusted basis of $1,000. Taxpayer A also has a 1971 multiple asset vintage account consisting of machines E, S, and C. Machines E and S, used in processing butter, each has an unadjusted basis of $10,000. Machine C used in capping bottles has an unadjusted basis of $1,000. In 1975, taxpayer A changes to the use of paper milk cartons and disposes of all bottle washing machines (X, Y, and Z) as well as machine C which was used in capping bottles. The sales of machine C, X, Y, and Z are the direct result of the termination of a manufacturing process. However, since the total unadjusted basis of the eligible section 1245 property retired as a direct result of such event is only $4,000 (which is less than 20 percent of the total unadjusted basis of machines E, S, C, X, Y, and Z, $24,000) the sales are ordinary retirements. All the assets are in the same asset guideline class and are of the same vintage. Accordingly, machines E, S, C, X, Y, and Z are for this purpose treated as being in a single vintage account.

Example (2). The facts are the same as in example (1) except that in 1976, taxpayer A sells six of his 12 milk delivery trucks as a direct result of eliminating home deliveries to customers in the suburbs. Deliveries within the city require only six trucks. Each of the trucks has an unadjusted basis of $3,000. Six of the taxpayer's delivery trucks are in a multiple asset vintage account of 1974 and six are in a multiple asset vintage account of 1972. Neither account contains any other property. Four trucks are retired from the 1972 vintage account and two trucks are retired from the 1974 vintage account. The sales result from the curtailment of taxpayer A's home delivery operation. The unadjusted basis of the four trucks retired from the 1972 vintage exceeds 20 percent of the total unadjusted basis of the affected account. The same is true for the two trucks retired from the 1974 vintage account. The sales of the trucks are extraordinary retirements.

(iii) *Treatment of ordinary retirements.* No loss shall be recognized upon an ordinary retirement. Gain shall be recognized only to the extent specified in this subparagraph. All proceeds from ordinary retirements shall be added to the depreciation reserve of the vintage account from which the retirement occurs. See subdivision (vi) of this subparagraph for optional allocation of basis in the case of a special basis vintage account. See subdivision (ix) of this subparagraph for recognition of gain when the depreciation reserve exceeds the unadjusted basis of the vintage account. The amount of salvage value for a vintage account shall be reduced (but not below zero) as of the beginning of the taxable year by the excess of (*a*) the depreciation reserve for the account, after adjustment for depreciation allowable for such taxable year and all other adjustments prescribed by this section (other than the adjustment prescribed by subdivision (ix) of this subparagraph), over (*b*) the unadjusted basis of the account less the amount of salvage value for the account before such reduction. Thus, in the case of a vintage account with an unadjusted basis of $1,000 and a salvage value of $100, to the extent that proceeds from ordinary retirements increase the depreciation reserve above $900, the salvage value is reduced. If the proceeds increase the depreciation reserve for the account to $1,000, the salvage value is reduced to zero. The unadjusted basis of the asset retired in an ordinary retirement is not removed from the account and the depreciation reserve for the account is not reduced by the depreciation allowable for the retired asset. The previously unrecovered basis of the retired asset will be recovered through the allowance for depreciation with respect to the vintage account. See subdivision (v)(*a*) of this subparagraph for treatment of retirements on which gain or loss is not recognized in whole or in part. See subdivision (v)(*b*) of this subparagraph for treatment of retirements by disposition to a member of an affiliated group as defined in section 1504(a). See subdivision (v) (*c*) of this subparagraph for treatment of transfers between members of an affiliated group of corporations or other related parties as extraordinary retirements.

(iv) *Treatment of extraordinary retirements.* (*a*) Unless the transaction is

governed by a special nonrecognition section of the Code such as 1031 or 337 or is one to which subdivision (v)(*b*) of this subparagraph applies, gain or loss shall be recognized upon an extraordinary retirement in the taxable year in which such retirement occurs subject to section 1231, section 165, and all other applicable provisions of law such as sections 1245 and 1250. If the asset which is retired in an extraordinary retirement is the only or last asset in the account, the account shall terminate and no longer be an account to which this section applies. In all other cases, the unadjusted basis of the retired asset shall be removed from the unadjusted basis of the vintage account, and the depreciation reserve established for the account shall be reduced by the depreciation allowable for the retired asset computed in the manner prescribed in paragraph (c)(1)(v)(*b*) of this section for determination of the adjusted basis of the asset. See subdivision (ix) of this subparagraph for recognition of gain in the case of an account containing section 1245 property when the depreciation reserve exceeds the unadjusted basis of the vintage account. See subdivision (iii) of this subparagraph for reduction of salvage value for such an account when the depreciation reserve exceeds the unadjusted basis of the account minus salvage value. See subdivision (v)(*b*) of this subparagraph for treatment of retirements by disposition to a member of an affiliated group as defined in section 1504(a).

(*b*) The principles of this subdivision may be illustrated by the following examples:

Example (1). Corporation X has a multiple asset vintage account of 1971 consisting of assets K, R, A, and P all of which are section 1245 property. The unadjusted basis of the account is $40,000. The unadjusted basis of asset A is $10,000. When the reserve for depreciation for the account is $20,000, asset A is sold in an extraordinary retirement for $8,000 in cash. The $10,000 unadjusted basis of asset A is removed from the account and the $5,000 depreciation allowable for asset A is removed from the reserve for depreciation. Gain in the amount of $3,000 (to which section 1245 applies) is recognized upon the sale of asset A.

Example (2). Corporation X has an item vintage account of 1972 consisting of residential apartment unit A. Unit A is section 1250 property. It is residential rental property and meets the requirements of section 167(j)(2). Corporation X adopts the declining balance method of depreciation using a rate twice the straight line rate. The asset depreciation period is 40 years. Unit A has an unadjusted basis of $200,000. On June 30, 1974, when the reserve for depreciation for the account is $19,500, unit A is sold for $220,000. Since unit A is section 1250 property, the sale is an extraordinary retirement in accordance with subdivision (ii)(*a*) of this subparagraph (without regard to subdivision (ii) (*b*) or (*c*) of this subparagraph). The adjusted basis of unit A is $180,500. Gain in the amount of $39,500 is recognized. The "additional depreciation" (as defined in section 1250(b)) for unit A is $9,500. Accordingly, $9,500 is in accordance with section 1250 treated as gain from the sale or exchange of an asset which is neither a capital asset nor property described in section 1231. The $30,000 balance of the gain from the sale of unit A may be gain to which section 1231 applies.

(v) *Special rule for certain retirements.* (*a*) In the case of an ordinary retirement on which gain or loss is in whole or in part not recognized because of a special nonrecognition section of the Code, such as 1031 or 337, no part of the proceeds from such retirement shall be added to the depreciation reserve of the vintage account in accordance with subdivision (iii) of this subparagraph. Instead, such retirement shall for all purposes of this section be treated as an extraordinary retirement.

(*b*) The provisions of § 1.1502-13 shall apply to a retirement which results in "deferred gain or loss" within the meaning of paragraph (c) of § 1.1502-13. In the case of an ordinary retirement to which the provisions of § 1.1502-13 apply, no part of the proceeds from such retirement shall be added to the depreciation reserve of the vintage account in accordance with subdivision (iii) of this subparagraph. Instead, such retirement shall for all purposes of this section be treated as an extraordinary retirement.

(*c*) In a case in which property is transferred, in a transaction which would without regard to this subdivision be treated as an ordinary retirement, during the taxable year in which first placed in service to a person who bears a relationship de-

scribed in section 179(d)(2) (A) or (B), such transfer shall for all purposes of this section be treated as an extraordinary retirement.

(*d*)(*1*) If, in the case of mass assets, it is impracticable for the taxpayer to maintain records from which he can establish the vintage of such assets as retirements occur, and if he adopts other reasonable recordkeeping practices, then the vintage of mass asset retirements may be determined by use of an appropriate mortality dispersion table. Such a mortality dispersion table may be based upon an acceptable sampling of the taxpayer's actual experience or other acceptable statistical or engineering techniques. Alternatively, the taxpayer may use a standard mortality dispersion table prescribed by the Commissioner for this purpose. If the taxpayer uses such standard mortality dispersion table for any taxable year of election, it must be used for all subsequent taxable years of election unless the taxpayer obtains the consent of the Commissioner to change to another dispersion table or to actual identification of retirements. For information requirements regarding mass assets, see paragraph (f)(5) of this section.

(*2*) For purposes of this section, the term "mass assets" has the same meaning as when used in paragraph (e)(4) of § 1.47-1.

(*e*) The principles of this subdivision may be illustrated by the following examples:

Example (1). Corporation X has a vintage account of 1971 consisting of machines A, B, and C, each with an unadjusted basis of $1,000. The unadjusted basis of the account is $3,000 and at the end of 1977 the reserve for depreciation is $2,100. On January 1, 1978, machine A is transferred to corporation Y solely for stock in the amount of $1,400 in a transaction to which section 351 applies. Since the adjusted basis of machine A is $300, a gain of $1,100 is realized, but no gain is recognized under section 351. Even though machine A was transferred in an ordinary retirement in accordance with (*a*) of this subdivision the rules for an extraordinary retirement are applied. The proceeds are not added to the reserve for depreciation for the account. Machine A is removed from the account, the unadjusted basis of the account is reduced by $1,000, and the reserve for depreciation for the account is reduced by $700.

Example (2). The facts are the same as in example (1) except that the consideration received for machine A is stock of corporation Y in the amount of $1,200 and cash in the amount of $200. The result is the same as in example (1) except that gain is recognized in the amount of $200 all of which is gain to which section 1245 applies.

Example (3). The facts are the same as in example (1) except that machine A is sold for $1,400 cash in an ordinary retirement and corporation X and corporation Y are includible corporations in an affiliated group as defined in section 1504(a) which files a consolidated return for 1978. The affiliated group has not elected under paragraph (c)(3) of § 1.1502-13 not to defer gain or loss. Accordingly, (*b*) of this subdivision applies. The retirement is treated as an extraordinary retirement. Machine A is removed from the account, the unadjusted basis of the account is reduced by $1,000, and the reserve for depreciation for the account is reduced by $700. The gain of $1,100 is deferred gain to which § 1.1502-13 applies.

(vi) *Treatment of special basis vintage accounts.* A "special basis vintage account" is a vintage account for an amount of property improvement determined under subparagraph (2)(vii)(*a*) of this paragraph. In general, reference in this section to a "vintage account" shall include a special basis vintage account. The unadjusted basis of a special basis vintage account shall be recovered through the allowance for depreciation in accordance with this section over the asset depreciation period for the account. Except as provided in this subdivision, the unadjusted basis, adjusted basis and reserve for depreciation of such account shall not be allocated to any specific asset in the asset guideline class, and the provisions of this subparagraph shall not apply to such account. However, in the event of a sale, exchange or other disposition of "repair allowance property" (as described in subparagraph (2)(iii) of this paragraph) in an extraordinary retirement as described in subdivision (ii) of this subparagraph (or if the asset is not in a vintage account, in an abnormal retirement as described in § 1.167(a)-8), the taxpayer may, if consistently applied to all such retirements in the taxable year and adequately identified in the taxpayer's books and records, elect to allocate the adjusted basis (as of the end of the taxable year) of all special basis vin-

tage accounts for the asset guideline class to each such retired asset in the proportion that the adjusted basis of the retired asset (as of the beginning of the taxable year) bears to the adjusted basis of all repair allowance property in the asset guideline class at the beginning of the taxable year. The election to allocate basis in accordance with this subdivision shall be made on the tax return filed for the taxable year. The principles of this subdivision may be illustrated by the following example:

Example. In addition to other property, the taxpayer has machines A, B, and C all in the same asset guideline class and each with an adjusted basis on January 1, 1977, of $10,000. The adjusted basis on January 1, 1977, of all repair allowance property (as described in subparagraph (2)(iii) of this paragraph) in the asset guideline class is $90,000. The machines are sold in an extraordinary retirement in 1977. The taxpayer is entitled to and does elect to allocate basis in accordance with this subdivision. There is also a 1972 special basis vintage account for the asset guideline class, as follows:

	Unadjusted basis	Reserve for depreciation	Dec. 31, 1977, adjusted basis
1972 special basis vintage account, for which the taxpayer selected an asset depreciation period of 10 years, adopted the straight line method, and used the half-year convention	$2,000	$1,100	$900

By application of this subdivision, the adjusted basis of machines A, B, and C is increased to $10,100 each (that is, $10,000 − $90,000 ÷ $900 = $100). The unadjusted basis, reserve for depreciation and adjusted basis of the special basis vintage account are reduced, respectively, by one-third (that is, $300 ÷ $900 = ⅓) in order to reflect the allocation of basis from the special basis vintage account.

(vii) *Reduction in the salvage value of a vintage account.* (*a*) A taxpayer may apply this section without reducing the salvage value for a vintage account in accordance with this subdivision or in accordance with subdivision (viii) of this subparagraph (relating to transfers to supplies or scrap). See subdivision (iii) of this subparagraph for reduction of salvage value in certain circumstances in the amount of proceeds from ordinary retirements.

(*b*) However, the taxpayer may, at his option, follow the consistent practice of reducing, as retirements occur, the salvage value for a vintage account by the amount of salvage value attributable to the retired asset, or the taxpayer may consistently follow the practice of so reducing the salvage value for a vintage account as extraordinary retirements occur while not reducing the salvage value for the account as ordinary retirements occur. If the taxpayer does not reduce the salvage value for a vintage account as ordinary retirements occur, the taxpayer may be entitled to a deduction in the taxable year in which the last asset is retired from the account in accordance with subdivision (ix) (*b*) of this subparagraph.

(*c*) For purposes of this subdivision, the portion of the salvage value for a vintage account attributable to a retired asset may be determined by multiplying the salvage value for the account by a fraction, the numerator of which is the unadjusted basis of the retired asset and the denominator of which is the unadjusted basis of the account, or any other method consistently applied which reasonably reflects that portion of the salvage value for the account originally attributable to the retired asset.

(*d*) In the case of ordinary retirements the taxpayer may—

(*1*) In the case of retirements (other than by transfer to supplies or scrap) follow the consistent practice of reducing the salvage value for the account by the amount of salvage value attributable to the retired asset and not adding the same amount to the depreciation reserve for the account, and

(*2*) In the case of retirements by transfer to supplies or scrap, follow the consistent practice of reducing the salvage value for the account by the amount of salvage value attributable to the retired asset and not adding the same amount to the depreciation reserve for the account (in which case the basis in the supplies or scrap account of the retired asset will be zero) or follow the consistent practice of reducing the salvage value for the ac-

count by the amount of salvage value attributable to the retired asset and adding the same amount to the depreciation reserve for the account (up to an amount which does not increase the depreciation reserve to an amount in excess of the unadjusted basis of the account) in which case the basis in the supplies or scrap account of the retired asset will be the amount added to the depreciation reserve for the account.

Thus, for example, in the case of an ordinary retirement by transfer of an asset to supplies or scrap, the basis of the asset in the supplies or scrap account would either be zero or the amount added to the depreciation reserve of the vintage account from which the retirement occurred. When the depreciation reserve for the account equals the unadjusted basis of the account no further adjustment to salvage value for the account will be made. See subdivision (viii) of this subparagraph for special optional rule for reduction of salvage value in the case of an ordinary retirement by transfer of an asset to supplies or scrap.

(*e*) In the event of a removal of property from a vintage account in accordance with paragraph (b)(4)(iii)(*e*), (5)(v)(*b*) or (6)(iii) of this section the salvage value for the account may be reduced by the amount of salvage value attributable to the asset removed determined as provided in (*c*) of this subdivision.

(viii) *Special optional adjustments for transfers to supplies or scrap.* If the taxpayer does not follow the consistent practice of reducing, as ordinary retirements occur, the salvage value for a vintage account in accordance with subdivision (vii) of this subparagraph, the taxpayer may (in lieu of the method described in subdivision (vii) (*c*) and (*d*) of this subparagraph) follow the consistent practice of reducing salvage value as ordinary retirements occur by transfer of assets to supplies or scrap and of determining the basis (in the supplies or scrap account) as assets retired in an ordinary retirement by transfer to supplies or scrap, in the following manner—

(*a*) The taxpayer may determine the value of the asset (not to exceed its unadjusted basis) by any reasonable method consistently applied (such as average cost, conditioned cost, or fair market value) if such method is adequately identified in the taxpayer's books and records.

(*b*) The value attributable to the asset determined in accordance with (*a*) of this subdivision shall be subtracted from the salvage value for the account (to the extent thereof) and the greater of (*1*) the amount subtracted from the salvage value for the vintage account and (*2*) the value of the asset determined in accordance with (*a*) of this subdivision, shall be added to the reserve for depreciation of this vintage account.

(*c*) The amount added to the reserve for depreciation of the vintage account in accordance with (*b*) of this subdivision shall be treated as the basis of the retired asset in the supplies or scrap account.

If the taxpayer makes the adjustments in accordance with this subdivision, the reserve for depreciation of the vintage account may exceed the unadjusted basis of the account, and in that event gain will be recognized in accordance with subdivision (ix) of this subparagraph.

(ix) *Recognition of gain or loss in certain situations.* (*a*) In the case of a vintage account for section 1245 property, if at the end of any taxable year after adjustment for depreciation allowable for such taxable year and all other adjustments prescribed by this section, the depreciation reserve established for such account exceeds the unadjusted basis of the account, the entire amount of such excess shall be recognized as gain in such taxable year. Such gain—

(*1*) Shall constitute gain to which section 1245 applies to the extent that it does not exceed the total amount of depreciation allowances in the depreciation reserve at the end of such taxable year, reduced by gain recognized pursuant to this subdivision with respect to the account previously treated as gain to which section 1245 applies, and

(*2*) May constitute gain to which section 1231 applies to the extent that it exceeds such total amount as so reduced.

In such event, the depreciation reserve shall be reduced by the amount of gain recognized, so that after such reduction the amount of the depreciation reserve is equal to the unadjusted basis of the account.

(*b*) In the case of an account for section 1245 property, if at the time the last asset in the vintage account is retired the unadjusted basis of the account exceeds the depreciation reserve for the account (after all adjustments prescribed by this section), the entire amount of such excess shall be recognized in such taxable year as a loss under section 165 or as a deduction for depreciation under section 167. If the retirement of such asset occurs by sale or exchange on which gain or loss is recognized, the amount of such excess may constitute a loss subject to section 1231. Upon retirement of the last asset in a vintage account, the account shall terminate and no longer be an account to which this section applies. See subdivision (xi) of this subparagraph for treatment of certain multiple asset and item accounts.

(*c*) The principles of this subdivision may be illustrated by the following example:

Example. The taxpayer has a vintage account for section 1245 property with an unadjusted basis of $1,000 and a depreciation reserve of $700 (of which $600 represents depreciation allowances and $100 represents the proceeds of ordinary retirements from the account). If $500 is realized during the taxable year from ordinary retirements of assets from the account, the reserve is increased to $1,200, gain is recognized to the extent of $200 (the amount by which the depreciation reserve before further adjustment exceeds $1,000) and the depreciation reserve is then decreased to $1,000. The $200 of gain constitutes gain to which section 1245 applies. If the amount realized from ordinary retirements during the year had been $1,100 instead of $500, the gain of $800 would have consisted of $600 of gain to which section 1245 applies and $200 of gain to which section 1231 may apply.

(x) *Dismantling cost.* The cost of dismantling, demolishing, or removing an asset in the process of a retirement from the vintage account shall be treated as an expense deductible in the year paid or incurred, and such cost shall not be subtracted from the depreciation reserve for the account.

(xi) *Special rule for treatment of multiple asset and item accounts.* For the purposes of subdivision (ix)(*b*) of this subparagraph, all accounts (other than a special basis vintage account as described in subdivision (vi) of this subparagraph) of the same vintage in the same asset guideline class for which the taxpayer has selected the same asset depreciation period and adopted the same method of depreciation, and which contain only section 1245 property permitted by paragraph (b)(3)(ii) of this section to be included in the same vintage account, shall be treated as a single multiple asset vintage account.

(4) *Examples.* The principles of this paragraph may be illustrated by the following examples:

Example (1). (*a*) Taxpayer A has a multiple asset vintage account for selection 1245 property with an unadjusted basis of $1,000. All the assets were first placed in service by A on January 15, 1971. This account contains all of A's assets in a single asset guideline class. A elects to apply this section for 1971 and adopts the modified half-year convention. A estimates a salvage value for the account of $100 and this estimate is determined to be reasonable. (See subparagraph (1)(v) of this paragraph for limitation on adjustment of reasonable salvage value.) A adopts the straight line method of depreciation with respect to the account and selects a 10-year asset depreciation period. A does not follow a practice of reducing the salvage value for the account in the amount of salvage value attributable to each retired asset in accordance with subparagraph (3)(vii) of this paragraph. The depreciation allowance for each of the first 4 years is $100, that is $\frac{1}{10}$ multiplied by the unadjusted basis of $1,000, with reduction for salvage.

(*b*) In the fifth year of the asset depreciation period, three assets are sold in an ordinary retirement for $300. Under paragraph (c)(1)(ii) of this section and subparagraph (3)(iii) of this paragraph, the proceeds of the retirement are added to the depreciation reserve as of the beginning of the fifth year. Accordingly, the reserve as of the beginning of the fifth year is $700, that is, $400 of depreciation as of the beginning of the year plus $300 proceeds from ordinary retirements. The depreciation allowance for the fifth year is $100, that is $\frac{1}{10}$ multiplied by the unadjusted basis of $1,000, without reduction for salvage. Accordingly, the depreciation reserve at the end of the fifth year is $800.

(*c*) In the sixth year, asset X is sold in an extraordinary retirement for $30 and gain

or loss is recognized. Under the first-year convention used by the taxpayer, the unadjusted basis of X, $300, is removed from the unadjusted basis of the vintage account as of the beginning of the sixth year and the depreciation reserve as of the beginning of such year is reduced to $650 by removing the depreciation applicable to asset X, $150 (see subparagraph (3)(iv) of this paragraph). Since the depreciation reserve ($650) exceeds the unadjusted basis of the account ($700) minus salvage value ($100) by $50, under subparagraph (3)(iii) of this paragraph, salvage value is reduced by $50. No depreciation is allowable for the sixth year.

(d) In the seventh year, an asset is sold in an ordinary retirement for $110. This would increase the reserve as of the beginning of the seventh year to $760 and under subparagraph (3)(iii) of this paragraph the salvage value is reduced to zero. Under subparagraph (3)(ix)(*a*) of this paragraph the depreciation reserve is then decreased to $700 (the unadjusted basis of the account) and $60 is reported as gain, without regard to the adjusted basis of the asset. No depreciation is allowable for the seventh year since the depreciation reserve ($700) equals the unadjusted basis of the account ($700).

(e)(1) In the eighth year, A elects to apply this section and to treat expenditures during the year for repair, maintenance, rehabilitation or improvement under subparagraph (2)(iii) and (iv)(*a*) of this paragraph (the "guideline class repair allowance"). This results in the treatment of $300 as a property improvement for the asset guideline class. (See subparagraph (2)(vii) of this paragraph for definition of a property improvement.) The property improvement is capitalized in a special basis vintage account of the eighth taxable year (see subparagraph (2)(viii)(*a*) of this paragraph). A selects an asset depreciation period of 10 years and adopts the straight line method for the special basis vintage account. A adopts the modified half-year convention for the eighth year.

(2) In the eighth year, A sells asset Y in an ordinary retirement for $175. Under paragraph (c)(1)(ii) of this section and subparagraph (3)(iii) of this paragraph, $175 is added to the depreciation reserve for the account as of the beginning of the taxable year. Since the depreciation reserve for the account ($875) exceeds the unadjusted basis of the account ($700) by $175, that amount of gain is recognized under subparagraph (3)(ix) of this paragraph. Upon recognition of gain in the amount of $175, the depreciation reserve for the account is reduced to $700.

(3) No depreciation is allowable in the eighth year for the vintage account since the depreciation reserve ($700) equals the unadjusted basis of the account ($700). The depreciation allowable in the eighth year for the special basis vintage account is $15, that is, unadjusted basis of $300, multiplied by 1/10, the asset depreciation period selected for the special basis vintage account, but limited to $15 under the modified half-year convention. (See paragraph (e)(1)(iv) of this section for treatment of $150 of the property improvement as first placed in service in the first half of the taxable year and $150 of the property improvement as first placed in service in the last half of the taxable year.)

Example (2). Taxpayer B has a 1971 multiple asset vintage account for section 1245 property with an unadjusted basis of $100,000. B selects from the asset depreciation range an asset depreciation period of 10 years and adopts the straight line method of depreciation and the modified half-year convention. B establishes a salvage value for the account of $10,000. All the assets in the account are first placed in service on January 15, 1971. B follows the practice of reducing salvage value for the account as ordinary retirements occur in accordance with subparagraph (3)(vii) of this paragraph, but does not follow the optional practice of determining the basis of assets transferred to supplies or scrap in accordance with subparagraph (3)(vii) of this paragraph. No retirements occur during the first five years. The depreciation reserve at the beginning of the sixth year is $50,000. In the sixth year an asset with an unadjusted basis of $20,000 is transferred to supplies in an ordinary retirement. By application of subparagraph (3)(vii) (*c*) and (*d*)(*2*) of this paragraph B determines the reduction in salvage value for the account attributable to such asset to be

$2,000 (that is, $20,000 ÷ $100,000 × $10,000 = $2,000).

B reduces the salvage value for the account by $2,000 and adds 2,000 to the depreciation reserve for the account. The basis of the retired asset in the supplies account is $2,000. The depreciation allowable for the account for the sixth year is $10,000. The depreciation reserve for the account at the beginning of the seventh year is $62,000. At the mid-point of the seventh year all the remaining assets in the account are sold in an ordinary retirement for $20,000, which is added to the depreciation reserve as of the beginning of the seventh year, thus increasing the reserve to $82,000. The $5,000 depreciation allowable for the account for the seventh year (one-half of a full-year's depreciation of $10,000) increases the depreciation reserve to $87,000. Under subparagraph (3)(ix)(*b*) of this paragraph, a loss of $13,000 subject to section 1231 is realized in the seventh year (that is, the excess of the unadjusted basis of $100,000 over the depre-

ciation reserve of $87,000). No depreciation is allowable for the account after the midpoint of the seventh year since all the assets are retired and the account has terminated.

(e) *Accounting for eligible property*—(1) *Definition of first placed in service*—(i) *In general.* The term "first placed in service" refers to the time the property is first placed in service by the taxpayer, not to the first time the property is placed in service. Property is first placed in service when first placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity. In general, the provisions of paragraph (d)(1)(ii) and (d)(2) of § 1.46-3 shall apply for the purpose of determining the date on which property is placed in service, but see subdivision (ii) of this subparagraph for special rule for certain replacement parts. In the case of a building which is intended to house machinery and equipment and which is constructed, reconstructed, or erected by or for the taxpayer and for the taxpayer's use, the building will ordinarily be placed in service on the date such construction, reconstruction, or erection is substantially complete and the building is in a condition or state of readiness and availability. Thus, for example, in the case of a factory building, such readiness and availability shall be determined without regard to whether the machinery or equipment which the building houses, or is intended to house, has been placed in service. However, in an appropriate case, as for example where the building is essentially an item of machinery or equipment, or the use of the building is so closely related to the use of the machinery or equipment that it clearly can be expected to be replaced or retired when the property it initially houses is replaced or retired, the determination of readiness or availability of the building shall be made by taking into account the readiness and availability of such machinery or equipment. The date on which depreciation begins under a convention used by the taxpayer or under a particular method of depreciation, such as the unit of production method or the retirement method, shall not determine the date on which the property is first placed in service. See paragraph (c)(2) of this section for application of a first-year convention to determine the allowance for depreciation of property in a vintage account.

(ii) *Certain replacement parts.* Property (such as replacement parts) the cost or other basis of which is deducted as a repair expense in accordance with the asset guideline repair allowance described in paragraph (d)(2)(iii) of this section shall not be treated as placed in service.

(iii) *Property improvements and excluded additions.* (*a*) Except as provided in (*b*) of this subdivision, a property improvement determined under paragraph (d)(2)(vii)(*b*) of this section, and an excluded addition (other than an excluded addition referred to in the succeeding sentence) is first placed in service when its cost is paid or incurred. The general rule in subdivision (i) of this subparagraph applies to an excluded addition described in paragraph (d)(2)(vi) (*d*), (*e*), (*f*), or (*g*) of this section.

(*b*) If a property improvement or an excluded addition to which the first sentence of (*a*) of this subdivision applies is paid or incurred in part in one taxable year and in part in the succeeding taxable year (or in part in the first half of a taxable year and in part in the last half of the taxable year) the taxpayer may at his option consistently treat such property improvements and excluded additions under the general rule in subdivision (i) of this subparagraph.

(iv) *Certain property improvements.* In the case of an amount of property improvement determined under paragraph (d)(2)(vii)(*a*) of this section, one-half of such amount is first placed in service in the first half of the taxable year in which the cost is paid or incurred and one-half is first placed in service in the last half of such taxable year.

(v) *Special rules for clearing accounts.* In the case of public utilities which consistently account for certain property through "clearing accounts," the date on which such property is first placed in service shall be deter-

mined in accordance with rules to be prescribed by the Commissioner.

(2) *Special rules for transferred property.* If eligible property is first placed in service by the taxpayer during a taxable year of election, and the property is disposed of before the end of the taxable year, the election for such taxable year shall include such property unless such property is excluded in accordance with paragraph (b)(5) (iii), (iv, (v), (vi), or (vii) of this section.

(3) *Special rules in the case of certain transfers*—(i) *Transaction to which section 381(a) applies.* (*a*) In general the acquiring corporation in a transaction to which section 381(a) applies is for the purposes of this section treated as if it were the distributor or transferor corporation.

(*b*) If the distributor or transferor corporation (including any distributor or transferor corporation of any distributor or transferor corporation) has made an election to apply this section to eligible property transferred in a transaction to which section 381(a) applies, the acquiring corporation must segregate such eligible property (to which the distributor or transferor corporation elected to apply this section) into vintage accounts as nearly coextensive as possible with the vintage accounts created by the distributor or transferor corporation identified by reference to the year the property was first placed in service by the distributor or transferor corporation. The asset depreciation period for the vintage account in the hands of the distributor or transferor corporation must be used by the acquiring corporation. The method of depreciation adopted by the distributor or transferor corporation, shall be used by the acquiring corporation unless such corporation obtains the consent of the Commissioner to use another method of depreciation in accordance with paragraph (e) of § 1.446-1 or changes the method of depreciation under paragraph (c)(1)(iii) of this section.

(*c*) The acquiring corporation may apply this section to the property so acquired only if the distributor or transferor corporation elected to apply this section to such property.

(*d*) See paragraph (b)(7) of this section for special rule for certain property where there is a mere change in the form of conducting a trade or business.

(ii) *Partnerships, trusts, estates, donees, and corporations.* Except as provided in subdivision (i) of this subparagraph with respect to transactions to which section 381(a) applies and subdivision (iv) of this subparagraph with respect to certain transfers between members of an affiliated group of corporations or other related parties, if eligible property is placed in service by an individual, trust, estate, partnership or corporation, the election to apply this section shall be made by the individual, trust, estate, partnership or corporation placing such property in service. For example, if a partnership places in service property contributed to the partnership by a partner, the partnership may elect to apply this section to such property. If the partnership does not make the election, this section will not apply to such property. See paragraph (b)(7) of this section for special rule for certain property where there is mere change in the form of conducting a trade or business.

(iii) *Leased property.* The asset depreciation range and the asset depreciation period for eligible property subject to a lease shall be determined without regard to the period for which such property is leased, including any extensions or renewals of such period. See paragraph (b)(5)(v) of this section for exclusion of property amortized under paragraph (b) of § 1.162-11 from an election to apply this section. In the case of a lessor of property, unless there is an asset guideline class in effect for lessors of such property, the asset guideline class for such property shall be determined as if the property were owned by the lessee. However, in the case of an asset guideline class based upon the type of property (such as trucks or railroad cars) as distinguished from the activity in which used, the property shall be classified without regard to the activity of the lessee. Notwithstanding the preceding sentence, if a lease with respect to property, which would be includible in an asset guideline class based upon the type of property under the preceding sentence (such as trucks or railroad

cars), is entered into after March 12, 1971, and before April 23, 1973, or a written contract to execute such a lease is entered into during such period and such contract is binding on April 23, 1973, and at all times thereafter, and if the rent or rate of return is based on a classification of such property as if it were owned by the lessee, then such property shall be classified as if it were owned by the lessee. However, the preceding sentence shall not apply if pursuant to the terms or conditions of the lease or binding contract the rent or rate of return may be adjusted to take account of a change in the period for depreciation with respect to the property resulting from inclusion of the property in an asset guideline class based upon the type of property rather than in an asset guideline class based upon the activity of the lessee. Similarly, where the terms of such a lease or contract provide that the obligation of the taxpayer to enter into the lease is subject to a condition that the property be included in an asset guideline class based upon the activity of the lessee, the contract or lease will not be considered as binding upon the taxpayer, for purposes of this subdivision. See paragraph (b)(4)(iii)(*b*) of this section for general rule for classification of property according to primary use.

(iv) *Treatment of certain transfers between members of affiliated groups or other related persons.* If section 38 property in an asset guideline class (determined without regard to whether the taxpayer elects to apply this section) is transferred by the taxpayer to a person who bears a relationship described in section 179(d)(2) (A) or (B), such property is in the same asset guideline class in the hands of transferee, and the transfer is neither described in section 381(a) nor treated as a disposition or cessation within the meaning of section 47, then the asset guideline period for such property selected by the taxpayer under this section shall not be shorter than the period used for computing the qualified investment with respect to the property under section 46(c). In a case in which the asset depreciation range for the asset guideline class which includes such property does not include the period for depreciation used by the transferor in computing the qualified investment with respect to such property, the transferee will not be permitted to include such property in an election under this section. However, in such a case, the transferor of the property may recompute the qualified investment for the year the property was placed in service using a period for depreciation which falls within the asset depreciation range.

(f) *Election with respect to eligible property*—(1) *Time and manner of election*—(i) *In general.* An election to apply this section to eligible property shall be made with the income tax return filed for the taxable year in which the property is first placed in service (see paragraph (e)(1) of this section) by the taxpayer. In the case of an affiliated group of corporations (as defined in section 1504(a)) which makes a consolidated return with respect to income tax in accordance with section 1502 and the regulations thereunder, each corporation which joins in the making of such return may elect to apply this section for a taxable year. An election to compute the allowance for depreciation under this section is a method of accounting but the consent of the Commissioner will be deemed granted to make an annual election. For election by a partnership see section 703 (b) and paragraph (e)(3)(ii) of this section. If the taxpayer does not file a timely return (taking into account extensions of the time for filing) for the taxable year in which the property is first placed in service, the election shall be filed at the time the taxpayer files his first return for that year. The election may be made with an amended return filed within the time prescribed by law (including extensions) for filing the original return for the taxable year of election. If an election is not made within the time and in the manner prescribed in this paragraph, no election may be made for such taxable year (by the filing of an amended return or in any other manner) with respect to any eligible property placed in service in the taxable year.

(ii) *Other elections under this section.* All other elections under this section may be made only within the time

and in the manner prescribed by subdivision (i) of this subparagraph with respect to an election to apply this section.

(iii) *Effective date.* See paragraph (f)(6) of this section for the effective date of this paragraph.

(2) *Information required.* A taxpayer who elects to apply this section must specify in the election:

(i) That the taxpayer makes such election and consents to and agrees to apply, all the provisions of this section;

(ii) The asset guideline class for each vintage account of the taxable year;

(iii) The first-year convention adopted by the taxpayer for the taxable year of election;

(iv) Whether the special 10 percent used property rule described in paragraph (b)(5)(iii) of this section has been applied to exclude used property from the election;

(v) Whether the taxpayer elects to apply the asset guideline class repair allowance described in paragraph (d)(2)(iii) of this section;

(vi) Whether the taxpayer elects for the taxable year to allocate the adjusted basis of a special basis vintage account in accordance with paragraph (d)(3)(vi) of this section;

(vii) Whether any eligible property for which the taxpayer was not required or permitted to make an election was excluded because of the special rules of paragraph (b)(5)(v) or (6), or paragraph (e)(3)(i) or (iv) of this section;

(viii) Whether any "section 38 property" was excluded under paragraph (b)(5)(iv) of this section from the election to apply this section;

(ix) If the taxpayer is an electric or gas utility, whether the taxpayer elects to apply this section on the basis of a composite asset guideline class in accordance with paragraph (b)(4)(iii)(*a*) of this section; and

(x) Such other information as may reasonably be required.

The information required under this subparagraph may be provided in accordance with rules prescribed by the Commissioner for reasonable grouping of assets or accounts. Form 4832 is provided for making an election and for submission of the information required. An election may be made and the information submitted only in accordance with Form 4832. An election to apply this section will not be rendered invalid under this subparagraph so long as there is substantial compliance, in good faith, with the requirements of this subparagraph.

(3) *Irrevocable election.* An election to apply this section to eligible property for any taxable year may not be revoked or changed after the time for filing the election prescribed under subparagraph (1) of this paragraph has expired. No other election under this section may be revoked or changed after such time unless expressly provided for under this section. (See paragraph (b)(5)(v)(*b*) of this section for special rule.)

(4) *Special conditions to election to apply this section*—(i) *Maintenance of books and records.* The taxpayer may not elect to apply this section for a taxable year unless the taxpayer maintains the books and records required under this section. In addition to any other information required under this section, the taxpayer's books and records must specify—

(*a*) The asset depreciation period selected by the taxpayer for each vintage account;

(*b*) If the taxpayer applies the modified half-year convention, the total cost or other basis of all eligible property first placed in service in the first half of the taxable year and the total cost or other basis of all eligible property first placed in service in the last half of the taxable year;

(*c*) The unadjusted basis and salvage value for each vintage account, and the amount, if any, by which gross salvage value was decreased under section 167 (f);

(*d*) Each asset guideline class for which the taxpayer elects to apply the asset guideline class repair allowance described in paragraph (d)(2)(iii) of this section;

(*e*) The amount of property improvement, determined under paragraph (d)(2)(vii)(*a*) of this section, for each asset guideline class for which the taxpayer elects to apply the asset guideline class repair allowance;

(*f*) A reasonable description of property excluded from an election to

apply this section and the basis for the exclusion;

(*g*) The total unadjusted basis of all assets retired during the taxable year from each asset guideline class, and the proceeds realized during the taxable year from such retirements; and

(*h*) The vintage (that is, the taxable year in which established) of the assets retired during the year from each asset guideline class.

For purposes of paragraph (f) (4) (i) (*g*) and (*h*) of this section, all accounts of the same vintage and asset guideline class may be treated as a single account. The taxpayer must specify the information required under paragraph (f) (4) (i) (*g*) and (*h*) without regard to the retirement of an asset by transfer to a supplies account for reuse.

(ii) *Response to survey.* Taxpayers who elect to apply this section must respond to infrequent data surveys conducted by the Treasury Department. These periodic surveys, which will be conducted on the basis of scientifically sound sampling methods, are designed to obtain data (including industry asset acquisitions and retirements) used to keep the asset guideline classes and periods up to date.

(iii) *Effect of noncompliance.* An election to apply this section will not be rendered invalid under this subparagraph so long as there is substantial compliance, in good faith, with the requirements of this subparagraph.

(5) *Mass assets.* In the case of mass assets, if the taxpayer assigns retirements to vintage accounts in the manner provided in paragraph (d)(3)(v)(*c*) of this section, the following information must be supplied with form 4832:

(i) Whether the taxpayer used the standard mortality dispersion curve or a curve based upon his own experience, and

(ii) Such other reasonable information as may be required by the Commissioner.

(6) *Effective date.* The rules in this paragraph apply to elections for taxable years ending on or after December 31, 1978. In the case of an election for a taxable year ending before December 31, 1978, the rules in paragraph (f) of this section, in effect before the amendments made by T.D. 7593 approved January 11, 1979, shall apply. See 26 CFR § 1.167(a)-11(f) (1977) for paragraph (f) of this section as it appeared before the amendments made by T.D. 7593.

(g) *Relationship to other provisions*—(1) *Useful life*—(i) *In general.* Except as provided in subdivision (ii) of this subparagraph, an election to apply this section to eligible property constitutes an agreement under section 167(d) and this section to treat the asset depreciation period for each vintage account as the useful life of the property in such account for all purposes of the Code, including sections 46, 47, 48, 57, 163(d), 167(c), 167(f)(2), 179, 312(m), 514(a), and 4940(c). For example, since section 167(c) requires a useful life of at least 3 years and the asset depreciation period selected is treated as the useful life for purposes of section 167(c), the taxpayer may adopt a method of depreciation described in section 167(b) (2) or (3) for an account only if the asset depreciation period selected for the account is at least 3 years.

(ii) *Special rules.* (*a*) For the purposes of paragraph (d) of this section, the anticipated period of use (estimated at the close of the taxable year in which the asset is first placed in service) on the basis of which salvage value is estimated, shall be determined without regard to the asset depreciation period for the property.

(*b*) For the purposes of sections 162 and 263 and the regulations thereunder, whether an expenditure prolongs the life of an asset shall be determined on the basis of the anticipated period of use of the asset (estimated at the close of the taxable year in which the asset is first placed in service) without regard to the asset depreciation period for such asset.

(*c*) The determination whether a transaction with respect to qualified property constitutes a sale or a lease of such property shall be made without regard to the asset depreciation period for the property.

(*d*) The principles of this subdivision may be illustrated by the following example:

Example. Corporation X has assets in asset guideline class 32.3 which are used in

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the manufacture of stone and clay products. The asset depreciation range for assets in asset guideline class 32.3 is from 12 to 18 years. Assume that corporation X selects 14 years as the asset depreciation period for all assets in asset guideline class 32.3. Under paragraph (d)(1)(i) of this section, corporation X must estimate salvage value on the basis of the anticipated period of use of the property (determined as of the close of the taxable year in which the property is first placed in service). The anticipated period of use must also be used for purposes of sections 162 and 263 in determining whether an expenditure materially prolongs the useful life of an asset. The anticipated period of use of an asset is determined without regard to the asset depreciation period of 14 years. Corporation X has, among other assets in the asset guideline class, machines A, B, and C. Corporation X estimates the anticipated period of use of machines A, B, and C as 8 years, 14 years, and 22 years, respectively. These estimates are reasonable and will be used for estimating salvage value and for purposes of sections 162 and 263.

(2) *Section 167(d) agreements.* If the taxpayer has, prior to January 1, 1971, entered into a section 167(d) agreement which applies to any eligible property, the taxpayer will be permitted to withdraw the eligible property from the agreement provided that an election is made to apply this section to such property. The statement of intent to withdraw eligible property from such an agreement must be made in an election filed for the taxable year in which the property is first placed in service. The withdrawal, in accordance with this subparagraph, of any eligible property from a section 167(d) agreement shall not affect any other property covered by such an agreement.

(3) *Relationship to the straight line method*—(i) *In general.* For purposes of determining the amount of depreciation which would be allowable under the straight line method of depreciation, such amount shall be computed with respect to any property in a vintage account using the straight line method in the manner described in paragraph (c)(1)(i) of this section and a rate based upon the period for the vintage account selected from the asset depreciation range. Thus, for example, section 57(a)(3) requires a taxpayer to compute an amount using the straight line method of depreciation if the taxpayer uses an accelerated method of depreciation. For purposes of section 57(a)(3), the amount for property in a vintage account shall be computed using the asset depreciation period for the vintage account selected from the asset depreciation range. In the case of property to which the taxpayer does not elect to apply this section, such amount computed by using the straight line method shall be determined under § 1.167(b)-1 without regard to this section.

(ii) *Examples.* The principles of this subparagraph may be illustrated by the following example:

Example. (*a*) Corporation X places a new asset in service to which it elects to apply this section. The cost of the asset is $200,000 and the estimated salvage value is zero. The taxpayer selects 9 years from the applicable asset depreciation range of 8 to 12 years. Corporation X adopts the double declining balance method of depreciation and thus the rate of depreciation is 22.2 percent (twice the applicable straight line rate). The depreciation allowance in the first year would be $44,400, that is, 22.2 percent of $200,000.

(*b*) Assume that the provisions of section 57(a)(3) apply to the property. The amount of the tax preference would be $22,200, that is, the excess of the depreciation allowed under this section ($44,400) over the depreciation which would have been allowable if the taxpayer had used the period selected from the asset depreciation range and the straight line rate ($22,200).

(Secs. 167(m), 85 Stat. 508 (26 U.S.C. 167(m) and 7805, 68A Stat. 917 (26 U.S.C. 7805))

[T.D. 7272, 38 FR 9967, Apr. 23, 1973; 38 FR 12919, May 17, 1973; 38 FR 13482, May 22, 1973, as amended by T.D. 7315, 39 FR 20195, June 7, 1974; 39 FR 20681, June 13, 1974; T.D. 7593, 44 FR 5420, Jan. 26, 1979; 44 FR 14548, Mar. 13, 1979; T.D. 7763, 46 FR 6910, Jan. 22, 1981]

§ 1.167(a)-12 Depreciation based on class lives for property first placed in service before January 1, 1971.

(a) *In general*—(1) *Summary.* This section provides an elective class life system for determining the reasonable allowance for depreciation of certain classes of assets for taxable years ending after December 31, 1970. The system applies only to assets placed in service before January 1, 1971. Depreciation for such assets during periods prior to January 1, 1971, may have been determined in accordance with

Revenue Procedure 62-21. Accordingly, rules are provided which permit taxpayers to apply the system in taxable years ending after December 31, 1970, to such assets without the necessity of changing or regrouping their depreciation accounts other than as previously required by Revenue Procedure 62-21. The system is designed to minimize disputes between taxpayers and the Internal Revenue Service as to the useful life of assets, salvage value, and repairs. See § 1.167(a)-11 for a similar system for property placed in service after December 31, 1970. See paragraph (d)(2) of § 1.167(a)-11 for treatment of expenditures for the repair, maintenance, rehabilitation or improvement of certain property. The system provided by this section is optional with the taxpayer. An election under this section applies only to qualified property in an asset guideline class for which an election is made and only for the taxable year of election. The taxpayer's election is made with the income tax return for the taxable year. This section also revokes the reserve ratio test for taxable years ending after December 31, 1970, and provides transitional rules for taxpayers who after January 11, 1971, adopt Revenue Procedure 62-21 for a taxable year ending prior to January 1, 1971.

(2) *Revocation of reserve ratio test and other matters.* Except as otherwise expressly provided in this section and in paragraph (b)(5)(vi) of § 1.167(a)-11, the provisions of Revenue Procedure 62-21 shall not apply to any property for any taxable year ending after December 31, 1970, whether or not the taxpayer elects to apply this section to any property. See paragraph (f) of this section for rules for the adoption of Revenue Procedure 62-21 for taxable years ending prior to January 1, 1971.

(3) *Definition of qualified property.* The term "qualified property" means tangible property which is subject to the allowance for depreciation provided by section 167(a), but only if—

(i) An asset guideline class and asset guideline period are in effect for such property for the taxable year, and

(ii) The property is first placed in service by the taxpayer before January 1, 1971,

(iii) The property is placed in service before January 1, 1971, but first placed in service by the taxpayer after December 31, 1970, and is not includible in an election under § 1.167(a)-11 by reason of § 1.167(a)-11(b)(7) (property acquired as a result of a mere change in form) or § 1.167(a)-11(e)(3)(i) (certain property acquired in a transaction to which section 381(a) applies), or

(iv) The property is acquired and first placed in service by the taxpayer after December 31, 1970, pursuant to a binding written contract entered into prior to January 1, 1971, and is excluded in accordance with paragraph (b)(5)(iv) of § 1.167(a)-11 from an election to apply § 1.167(a)-11.

The provisions of paragraph (e)(1) of § 1.167(a)-11 apply in determining whether property is first placed in service before January 1, 1971. See subparagraph (4)(ii) of this paragraph for special rules for the exclusion of property from the definition of qualified property.

(4) *Requirements of election*—(i) *In general.* An election to apply this section to qualified property must be made within the time and in the manner specified in paragraph (e) of this section. The election must specify that the taxpayer consents to and agrees to apply all the provisions of this section. The election may be made separately for each asset guideline class. Thus, a taxpayer may for the taxable year elect to apply this section to one, more than one, or all asset guideline classes in which he has qualified property. An election to apply this section for a taxable year must include all qualified property in the asset guideline class for which the election is made.

(ii) *Special rules for exclusion of property from application of this section.* (*a*) If for the taxable year of election, the taxpayer computes depreciation under section 167(k) or computes amortization under sections 169, 185, 187, 188, or paragraph (b) of § 1.162-11 with respect to property, such property is not qualified property for such taxable year. If for the taxable year of election, the taxpayer computes depreciation under any method of depreci-

ation (other than a method described in the preceding sentence) not permitted by subparagraph (5)(v) of this paragraph for any property in an asset guideline class (other than subsidiary assets excluded from an election under (*b*) of this subdivision), no property in such asset guideline class is qualified property for such taxable year.

(*b*) The taxpayer may exclude from an election to apply this section all (but not less than all) subsidiary assets. Subsidiary assets so excluded are not qualified property for such taxable year. For purposes of this subdivision the term "subsidiary assets" includes jigs, dies, molds, returnable containers, glassware, silverware, textile mill cam assemblies, and other equipment includable in Group One, Class 5, of Revenue Procedure 62-21 which is usually and properly accounted for separately from other property and under a method of depreciation not expressed in terms of years.

(iii) *Special rule for certain public utility property.* (*a*) In the case of public utility property described in section 167(l)(3)(A)(iii) for which no guideline life was prescribed in Revenue Procedure 62-21 (or for which reference was made in Revenue Procedure 62-21 to lives or rates established by governmental regulatory agencies) of a taxpayer which—

(*1*) Is entitled to use a method of depreciation other than a "subsection (l) method" of depreciation (as defined in section 167(l)(3)(F)) only if it uses the "normalization method of accounting" (as defined in section 167(l)(3)(G)) with respect to such property, or

(*2*) Is entitled for the taxable year to use only a "subsection (l) method" of depreciation,

such property shall be qualified property (as defined in subparagraph (3) of this paragraph) only if the taxpayer normalizes the tax deferral resulting from the election to apply this section.

(*b*) The taxpayer will be considered to normalize the tax deferral resulting from the election to apply this section only if it computes its tax expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated book. f account using a period for depreciation no less than the period used for computing its depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account for the taxable year, and the taxpayer makes adjustments to a reserve to reflect the deferral of taxes resulting from the use of a period for depreciation under section 167 in accordance with an election to apply this section different from the period used for computing its depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account for the taxable year. A determination whether the taxpayer is considered to normalize under this subdivision the tax deferral resulting from the election to apply this section shall be made in a manner consistent with the principles for determining whether a taxpayer is using the "normalization method of accounting" (within the meaning of section 167(l)(3)(G)). See § 1.167(l)-1(h).

(*c*) If a taxpayer, which has elected to apply this section to any qualified public utility property and is required under (*a*) of this subdivision to normalize the tax deferral resulting from the election to apply this section to such property, fails to normalize such tax deferral, the election to apply this section to such property shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize such tax deferral. Application of this section to such property for any period prior to the termination date will not be affected by this termination.

(5) *Determination of reasonable allowance for depreciation*—(i) *In general.* The allowance for depreciation of qualified property to which the taxpayer elects to apply this section shall be determined in accordance with this section. The annual allowance for depreciation is determined by using the method of depreciation adopted by the taxpayer and a rate based upon a life permitted by this section. In the case of the straight-line method of depreciation, the rate of depreciation shall be based upon the class life (or individual life if the taxpayer assigns individual depreciable lives in accordance with subdivision (iii) of this subparagraph) used by the taxpayer with respect to

the assets in the asset guideline class. Such rate will be applied to the unadjusted basis of the asset guideline class (individual assets or depreciation accounts if the taxpayer assigns individual depreciable lives). In the case of the sum of the years-digits method of depreciation, the rate of depreciation will be determined based upon the remaining life of the class (or individual remaining lives if the taxpayer assigns such lives in accordance with subdivision (iii) of this subparagraph) and is applied to the adjusted basis of the class (or individual accounts or assets) as of the beginning of the taxable year of election. The remaining life of a depreciation account is determined by dividing the unrecovered cost or other basis of the account, as computed by straight-line depreciation, by the gross cost or unadjusted basis of the account, and multiplying the result by the class life used with respect to the account. In the case of the declining balance method of depreciation, the rate of depreciation for the asset guideline class shall be based upon the class life (or individual life if the taxpayer assigns such lives in accordance with subdivision (iii) of this subparagraph). Such rate is applied to the adjusted basis of the class (or individual accounts or assets) as of the beginning of the taxable year of election.

(ii) *Reasonable allowance by reference to class lives.* The amount of depreciation for all qualified property in an asset guideline class to which the taxpayer elects to apply this section will constitute the reasonable allowance provided by section 167(a) and the depreciation for the asset guideline class will not be adjusted if—

(*a*) The taxpayer's qualified property is accounted for in one or more depreciation accounts which conform to the asset guideline class, and the depreciation for each such account is determined by using a rate based upon a life not less than the class life, or

(*b*) The taxpayer's qualified property is accounted for in one or more depreciation accounts (whether or not conforming to the asset guideline class) for which depreciation is determined at a rate based upon the taxpayer's estimate of the lives of the assets (instead of the class life) and the total amount of depreciation so determined for the asset guideline class for the taxable year of election is not more than would be permitted under (*a*) of this subdivision for such year using the method of depreciation adopted by the taxpayer for the property.

See subdivision (vii) of this subparagraph for determination of reasonable allowance if depreciation exceeds the amount permitted by this subdivision. See paragraph (b) of this section for rules regarding the determination of "class life". For rules for regrouping depreciation accounts to conform to the asset guideline class, see subdivision (iv) of this subparagraph.

(iii) *Consistency when individual lives are used.* If the taxpayer assigns individual depreciable lives to assets in accordance with subdivision (ii)(*b*) of this subparagraph, even though the total amount of depreciation for the asset guideline class will not be adjusted, the lives assigned to the various assets in the asset guideline class must be reasonably in proportion to their relative expected periods of use in the taxpayer's business. Thus, although the taxpayer who uses individual asset lives normally has latitude in thereby allocating the depreciation for the asset guideline class among the assets, if the lives are grossly disproportionate (as where a short life is assigned to one asset and a long life to another even though the expected periods of use are the same), the taxpayer's allocation of depreciation to particular assets or depreciation accounts may be adjusted. For example, the taxpayer's allocation may be adjusted for purposes of determining adjusted basis under section 1016(a) or in allocating depreciation to the 50-percent limitation on percentage depletion provided by section 613(a). See paragraph (d) of this section for rules regarding the use of individual asset lives for purposes of classifying retirements as normal or abnormal.

(iv) *Regrouping depreciation accounts.* Without the consent of the Commissioner, the taxpayer may for any taxable year for which he elects to apply this section to an asset guideline class, regroup his accounts for that

and all succeeding taxable years to conform to the asset guideline class. Other changes in accounting, including a change from item accounts to multiple-asset accounting, may be made with the consent of the Commissioner. No depreciation accounts for which the straight line or sum of the years-digits method of depreciation is adopted may be combined under this section which would not be permitted to be combined under part III of Revenue Procedure 65-13, as in effect on January 1, 1971. Accordingly, whether or not the taxpayer adopted the guideline system of Revenue Procedure 62-21 for a taxable year to which part III of Revenue Procedure 65-13 is applicable, the depreciation allowance for any taxable year of election under this section may not exceed that amount which would have been allowed for such year if the taxpayer had used item accounts or year of acquisition accounts. Thus, for example, if a calendar year taxpayer acquired a $90 asset on the first day of each year from 1966 through 1970, placed such assets in a single multiple asset account, adopted the sum of the years-digits method of depreciation and used a 5-year depreciable life for such assets, and in 1971 uses the 5-year class life determined under paragraph (b) of this section, the depreciation allowance for such assets in 1971 under this section may not exceed $60, that is, the amount which would be allowed if the taxpayer had used year of acquisition accounts for the assets for the years 1966 through 1970.

For purposes of this subparagraph, a taxpayer's depreciation accounts conform to the asset guideline class if each depreciation account includes only assets of the same asset guideline class.

(v) *Method of depreciation.* The same method of depreciation must be applied to all property in a single depreciation account. The method of depreciation is subject to the limitations of section 167 (c), (j), and (l). Except as otherwise provided in this subdivision, the taxpayer must apply a method of depreciation described in section 167(b) (1), (2), or (3) for qualified property to which the taxpayer elects to apply this section. A method of depreciation permitted under section 167(b)(4) may be used under this section if the method was used by the taxpayer with respect to the property for his last taxable year ending before January 1, 1971, the method is expressed in terms of years, the taxpayer establishes to the satisfaction of the Commissioner that the method is both a reasonable and consistent method, and if the taxpayer applies paragraph (b)(2) of this section (relating to class lives in special situations) to determine a class life, that the method of determining such class life is consistent with the principles of Revenue Procedure 62-21 as applied to such a method. If the taxpayer has applied a method of depreciation with respect to the property which is not described in section 167(b) (1), (2), (3), or (4) (as permitted under the preceding sentence), he must change under this section to a method of depreciation described in section 167(b) (1), (2), or (3) for the first taxable year for which an election is made under this section. Other changes in depreciation method may be made with the consent of the Commissioner (see sec. 446 and the regulations thereunder). (See also sec. 167 (e).)

(vi) *Salvage value.* In applying the method of depreciation adopted by the taxpayer, the annual allowance for depreciation is determined without adjustment for the salvage value of the property, except that no depreciation account may be depreciated below a reasonable salvage value for the account. See paragraph (c) of this section for definition and treatment of salvage value.

(vii) *Reasonable allowance when depreciation exceeds amount based on class life.* In the event that the total amount of depreciation claimed by the taxpayer on his income tax return, in a claim for refund, or otherwise, for an asset guideline class with respect to which an election is made under this section for the taxable year, exceeds the maximum amount permitted under subdivision (ii) (*a*) of this subparagraph—

(*a*) If the excess is established to the satisfaction of the Commissioner to be the result of a good faith mistake by the taxpayer in determining the maxi-

mum amount permitted under subdivision (ii) (*a*) of this subparagraph, the taxpayer's election to apply this section will be treated as valid and only such excess will be disallowed, and

(*b*) In all other cases, the taxpayer's election to apply this section to the asset guideline class for the taxable year is invalid and the reasonable allowance for depreciation will be determined without regard to this section. (See § 1.167(a)-1 (b) for rules regarding the estimated useful life of property.)

(b) *Determination of class lives*—(1) *Class lives in general.* The class life determined under this paragraph (without regard to any range or variance permitted with respect to class lives under § 1.167(a)-11) will be applied for purposes of determining whether the allowance for depreciation for qualified property included in an election under this section is subject to adjustment. The taxpayer is not required to use the class life determined under this paragraph for purposes of determining the allowance for depreciation. Except as provided in subparagraph (2) of this paragraph, the class life of qualified property to which the taxpayer elects to apply this section is the shorter of—

(i) The asset guideline period for the asset guideline class as set forth in Revenue Procedure 72-10 as in effect on March 1, 1972 (applied without regard to any special provision therein with respect to property predominantly used outside the United States), or

(ii) The asset guideline period for the asset guideline class as set forth in any supplement or revision of Revenue Procedure 72-10, but only if and to the extent by express reference in such supplement or revision made applicable for the purpose of changing the asset guideline period or classification of qualified property to which this section applies.

See paragraph (e)(3)(iii) of this section for requirement that the election for the taxable year specify the class life for each asset guideline class. Generally, the applicable asset guideline class and asset guideline period for qualified property to which the taxpayer has elected to apply this section will not be changed for the taxable year of election to reflect any supplement or revision thereof after the taxable year. However, if expressly provided in such a supplement or revision, the taxpayer may, at his option in the manner specified therein, apply the revised or supplemented asset guideline classes or periods to such property for such taxable year and succeeding taxable years. The principles of this subparagraph may be illustrated by the following example:

Example. (i) Corporation X, a calendar year taxpayer, has assets in asset guideline class 20.4 of Revenue Procedure 72-10 which were placed in service by corporation X in 1967, 1968, and 1970. Corporation X also has assets in asset guideline class 22.1 of Revenue Procedure 72-10 which were placed in service at various times prior to 1971. Corporation X has no other qualified property. Corporation X elects to apply this section for 1971 to both classes. Assume that the class lives are determined under this subparagraph and not under subparagraph (2) of this paragraph.

(ii) The class lives for asset guideline classes 20.4 and 22.1 are their respective asset guideline periods of 12 years and 9 years in Revenue Procedure 72-10.

(iii) Accordingly, in the election for the taxable year, in accordance with paragraph (e)(3)(iii) of this section, corporation X specifies a class life of 12 years for asset guideline class 20.4 and a class life of 9 years for asset guideline class 22.1

(2) *Class lives in special situations.* Notwithstanding subparagraph (1) of this paragraph, for the purposes of this section the class life for the asset guideline class determined under this subparagraph shall be used if such class life is shorter than the class life determined under subparagraph (1) of this paragraph. If property described in paragraph (a)(2)(iii) of this section in an asset guideline class is acquired by the taxpayer in a transaction to which section 381(a) applies, for purposes of this subparagraph such property shall be segregated from other property in the class and treated as in a separate asset guideline class, and the class life for that asset guideline class under this subparagraph shall be the shortest class life the transferor was entitled to use under this section for such property on the date of such transfer. In all other cases, the class life for the asset guideline class for

purposes of this subparagraph shall be the shortest class life (within the meaning of sec. 4, part II, of Revenue Procedure 62-21) which can be justified by application of secs. 3.02(a), 3.03(a), or 3.05, part II, of Revenue Procedure 62-21 (other than the portion of such sec. 3.05 dealing with justification of a class life by reference to facts and circumstances) for the taxpayer's last taxable year ending prior to January 1, 1971.

A class life justified by application of section 3.03(a), Part II, of Revenue Procedure 62-21 shall not be shorter than can be justified under the Adjustment Table for Class Lives in Part III of such Revenue Procedure. For purposes of this subparagraph and paragraph (f)(1)(iii) of this section, the reserve ratio test is met only if the taxpayer's reserve ratio does not exceed the upper limit of the appropriate reserve ratio range or in the alternative during the transitional period there provided does not exceed the appropriate "transitional upper limit" in section 3, Part II, of Revenue Procedure 65-13. References to Revenue Procedure 62-21 include all morifications, amendments, and supplements thereto as of January 1, 1971. The guideline form of the reserve ratio test, as described in Revenue Procedure 65-13, may be applied for purposes of this subparagraph in a manner consistent with the rules contained in section 7, Part II, of Revenue Procedure 65-13 and sections 3.02, 3.03, and 3.05, Part II, of Revenue Procedure 62-21. The principles of this subparagraph may be illustrated by the following examples:

Example (1). Corporation X, a calendar year taxpayer, has all its assets in asset guideline class 20.4 of Revenue Procedure 72-10 which were placed in service by corporation X prior to 1971. Corporation X elects to apply this section for 1971. For taxable years 1967 through 1969, corporation X had used a class life (within the meaning of section 4, Part II, of Revenue Procedure 62-21) for asset guideline class 20.4 of 12 years. The asset guideline period in Revenue Procedure 72-10 in effect for 1971 is also 12 years. Assume that for 1969 corporation X's reserve ratio was below the appropriate reserve ratio lower limit. However, corporation X could not justify a class life shorter than the asset guideline period of 12 years for 1970 since corporation X had not used the 12-year class life for a period at least equal to one-half of 12 years. (See section 3.03(a), Part II, of Revenue Procedure 62-21.) Accordingly, the class life for asset guideline class 20.4 in 1971 is the asset guideline period of 12 years in accordance with subparagraph (1) of this paragraph.

Example (2). The facts are the same as in example (1) except that corporation X had used a class life of 10 years for guideline class 20.4 since 1967. Corporation X had not used the class life of 10 years for a period at least equal to one-half of 10 years. However, in 1968 corporation X's 10-year class life was accepted on audit by the Internal Revenue Service and corporation X met the reserve ratio test in 1970 for guideline class 20.4 using a test life of 10 years. (See section 3.05, Part II, of Revenue Procedure 62-21.) Accordingly, the class life of 10 years is justified for 1970 and the class life for 1971 is 10 years in accordance with this subparagraph. If the taxpayer's class life had not been audited and accepted for 1968, and in the absence of other circumstances, the taxpayer could not justify a class life shorter than the asset guideline period of 12 years since it had not used the 10-year class life for a period at least equal to one-half of 10 years. (See section 3.02, Part II, of Revenue Procedure 62-21.)

Example (3). Corporation Y, a calendar year taxpayer, has all its assets in asset guideline class 13.3 of Revenue Procedure 72-10 which were placed in service from 1960 through 1970. Corporation Y elects to apply this section for 1971. The asset guideline period in Revenue Procedure 72-10 in effect for 1971 is 16 years. Since 1963 corporation Y had used a class life of 16 years for asset guideline 13.3. At the end of 1969 corporation Y's reserve ratio for guideline class 13.3 was 36 percent. With a growth rate of 8 percent and a test life of 16 years the appropriate reserve ratio lower limit was 37 percent. Corporation Y's reserve ratio of 36 percent was below the lower limit of the appropriate reserve ratio range. Corporation Y had used the 16-year class life for at least eight years. A class life of 13.5 years for 1970 was justified by application of section 3.03(a), Part II, of Revenue Procedure 62-21 and the Adjustment Table for Class Lives in Part III, of Revenue Procedure 62-21. The class life for 1971 is 13.5 years in accordance with this subparagraph.

(3) *Classification of property*—(i) *In general.* Property to which this section applies shall be included in the asset guideline class for the activity in which the property is primarily used in the taxable year of election. See paragraph (d)(5) of this section for

rule regarding the classification of leased property.

(ii) *Insubstantial activity.* The provisions of Revenue Produce 62-21 with respect to classification of assets used in an activity which is insubstantial may be applied under this section.

(iii) *Special rule for certain public utilities.* An electric or gas utility which in accordance with Revenue Procedure 64-21 used a composite guideline class basis for applying Revenue Procedure 62-21 for its last taxable year prior to January 1, 1971, may apply Revenue Procedure 72-10 and this section on the basis of such composite asset guideline class determined as provided in Revenue Procedure 64-21. For the purposes of this section all property in the composite guideline class shall be treated as included in a single asset guideline class.

(c) *Salvage value*—(1) *In general*— (i) *Definition of gross salvage value.* "Gross salvage" value is the amount (determined at or as of the time of acquisition but without regard to the application of Revenue Procedure 62-21) which is estimated will be realized upon a sale or other disposition of qualified property when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service, without reduction for the cost of removal, dismantling, demolition, or similar operations. "Net salvage" is gross salvage reduced by the cost of removal, dismantling, demolition, or similar operations. If a taxpayer customarily sells or otherwise disposes of property at a time when such property is still in good operating condition, the gross salvage value of such property is the amount expected to be realized upon such sale or disposition, and under certain circumstances, as where such property is customarily sold at a time when it is still relatively new, the gross salvage value may constitute a relatively large proportion of the unadjusted basis of such property.

(ii) *Definition of salvage value.* "Salvage value" for purposes of this section means gross or net salvage value less the amount, if any, by which reduced by application of section 167(f). Generally, as provided in section 167(f), a taxpayer may reduce the gross or net salvage value for an account by an amount which does not exceed 10 percent of the unadjusted basis of the personal property (as defined in section 167(f)(2)) in the account.

(2) *Estimation of salvage value*—(i) *In general.* For the first taxable year for which he elects to apply this section, the taxpayer must (in accordance with paragraph (e)(3)(iv)(c) of this section) establish salvage value for all qualified property to which the election applies. The taxpayer may (in accordance with subparagraph (1) of this paragraph) determine either gross or net salvage, but an election under this section does not constitute permission to change the manner of estimating salvage. Permission to change the manner of estimating salvage must be obtained by filing form 3115 with the Commissioner of Internal Revenue, Washington, D.C. 20224, within the time otherwise permitted for the taxable year or before September 6, 1973. Salvage value in succeeding taxable years of election will be determined by adjustments of such initial salvage value for the account, as retirements occur. This salvage value established by the taxpayer for the first taxable year of election will not be redetermined merely as a result of fluctuations in price levels or as a result of other circumstances occurring after the close of such taxable year. See paragraph (e)(3)(iv) of this section for requirements that the taxpayer specify in his election the aggregate amount of salvage value for an asset guideline class and that the taxpayer maintain records reasonably sufficient to identify the salvage value established for each depreciation account in the class.

(ii) *Salvage as limitation on depreciation.* In no case may an account be depreciated under this section below a reasonable salvage value, after taking into account any reduction in gross or net salvage value permitted by section 167(f). For example, if the salvage value of an account for 1971 is $75, the unadjusted basis of the account is $500, and the depreciation reserve is $425, no depreciation is allowable for 1971.

(iii) *Special rule for first taxable year.* If for a taxable year ending prior to January 1, 1971, the taxpayer had adopted Revenue Procedure 62-21 prior to January 12, 1971 (see paragraph (f)(2) of this section), no adjustment in the amount of depreciation allowable for any taxable year ending prior to January 1, 1971, shall be made solely by reason of establishing salvage value under this paragraph for any taxable year ending after December 31, 1970. The principles of this subdivision may be illustrated by the following example:

Example. Taxpayer A had adopted Revenue Procedure 62-21 prior to January 12, 1971, for taxable years prior to 1971. Taxpayer A had not taken into account any salvage value for account No. 1 which is one of four depreciation accounts A has in the class. The reserve ratio test has been met for all years prior to 1971 and in accordance with Revenue Procedure 62-21 no adjustments in depreciable lives or salvage values were made. At the end of A's taxable year 1970, the unadjusted basis of account No. 1 was $10,000 and the reserve for depreciation was $9,800. Pursuant to this paragraph, A establishes a salvage value of $400 for account No. 1 (determined at or as of the time of acquisition). This salvage value is determined to be correct. No depreciation is allowable for account No. 1 in 1971. No depreciation is disallowed for any taxable year prior to 1971, solely by reason of establishing salvage value under this paragraph.

(3) *Limitation on adjustment of reasonable salvage value.* The salvage value established by the taxpayer for a depreciation account will not be redetermined if it is reasonable. Since the determination of salvage value is a matter of estimation, minimal adjustments will not be made. The salvage value established by the taxpayer will be deemed to be reasonable unless there is sufficient basis for a determination of an amount of salvage value for the account which exceeds the salvage value established by the taxpayer for the account by an amount greater than 10 percent of the unadjusted basis of the account at the close of such taxable year. If the salvage value established by the taxpayer for the account is not within the 10-percent range or if the taxpayer follows the practice of understating his estimates of salvage to take advantage of this subdivision, and if there is a determination of an amount of salvage value for the account for the taxable year which exceeds the salvage value established by the taxpayer for the account for such taxable year, an adjustment will be made by increasing the salvage value established by the taxpayer for the account by an amount equal to the difference between the salvage value as determined and the salvage value established by the taxpayer for the account. For the purposes of this subdivision, a determination of salvage value shall include all determinations at all levels of audit and appellate proceedings, and as well as all final determinations within the meaning of section 1313(a)(1). This subparagraph shall apply to each such determination.

(4) *Examples.* The principles of this paragraph may be illustrated by the following examples in which it is assumed that the taxpayer has established salvage value in accordance with this paragraph and has not followed a practice of understating his estimates of salvage value:

Example (1). Taxpayer B elects to apply this section for 1971. Assets Y and Z are the only assets in a multiple asset account of 1967, the year in which the assets were acquired. The unadjusted basis of asset Y is $50,000 and the unadjusted basis of asset Z is $30,000. B estimated a gross salvage value of $55,000 at the time of acquisition. The property qualified under section 167(f)(2) and B reduced the amount of salvage taken into account by $8,000 (that is, 10 percent of $80,000, under sec. 167(f)). Thus, in accordance with this paragraph and paragraph (e)(3)(iv)(c) of this section, B establishes a salvage value of $47,000 for the account for 1971. Assume that there is not sufficient basis for determining a salvage value for the account greater $52,000 (that is $60,000 minus the $8,000 reduction under sec. 167(f)). Since the salvage value of $47,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage for the account will not be redetermined.

Example (2). The facts are the same as in example (1) except that B estimated a gross salvage value of $50,000 and establishes a salvage value of $42,000 for the account (that is, $50,000 minus the $8,000 reduction under section 167(f)). There is sufficient basis for determining an amount of salvage value greater than $50,000 (that is, $58,000 minus the $8,000 reduction under section 167(f)). The salvage value of $42,000 estab-

lished by B for the account can be redetermined without regard to the limitation in subparagraph (3) of this paragraph, since it is not within the 10 percent range. Upon audit of B's tax return for 1971 (a year in which the redetermination would affect the amount of depreciation allowable for the account), salvage value is determined to be $52,000 after taking into account the reduction under section 167(f). Salvage value for the account will be adjusted to $52,000.

Example (3). The facts are the same as in example (1) except that upon audit of B's tax return for 1971 the examining officer determines the salvage value to be $58,000 (that is, $66,000 minus the $8,000 reduction under section 167(f)), and proposes to adjust salvage value for the account to $58,000 which will result in disallowing an amount of depreciation for the taxable year. B does not agree with the finding of the examining officer. After receipt of a "30-day letter," B waives a district conference and initiates proceedings before the Appellate Division. In consideration of the case by the Appellate Division it is concluded that there is not sufficient basis for determining an amount of salvage value for the account in excess of $55,000 (that is, $63,000 minus the $8,000 reduction under section 167(f)). Since the salvage value of $47,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage value for the account will not be redetermined.

Example (4).—For 1971, taxpayer C elects to apply this section to factory building X which is in an item account of 1965, the year in which the building was acquired. The unadjusted basis of factory building X is $90,000. C estimated a gross salvage value for the account of $10,000. The property did not qualify under section 167(f)(2). Thus, C establishes a salvage value of $10,000 for the account for 1971. Assume that there is not sufficient basis for determining a salvage value for the account greater than $14,000. Since the salvage value of $10,000 established by C for the account is within the 10-percent range, it is reasonable. Salvage value for the account will not be redetermined.

(d) *Accounting for qualified property*—(1) *In general.* Qualified property for which the taxpayer elects to apply this section may be accounted for in any number of item or multiple asset accounts.

(2) *Retirements of qualified property*—(i) *In general.* The provisions of this subparagraph and § 1.167(a)-8 apply to retirements of qualified property to which the taxpayer elects to apply this section for the taxable year. See subdivision (iii) of this subparagraph for special rule for normal retirements.

(ii) *Adjusted basis of assets retired.* In the case of a taxpayer who depreciates qualified property in a multiple-asset account conforming to the asset guideline class at a rate based on the class life in accordance with paragraph (a)(5)(ii)(*a*) of this section, § 1.167(a)-8(c) (relating to basis of assets retired) shall be applied by assuming that the class life is the average expected useful life of the assets in the account. See § 1.167(a)-8, generally, for the basis of assets retired.

(iii) *Definition of normal retirements.* Notwithstanding § 1.167(a)-8(b), the determination whether a retirement of qualified property is normal or abnormal shall be made in light of all the facts and circumstances, primarily with reference to the expected period of use of the asset in the taxpayer's business without regard to paragraph (a)(5)(ii) of this section. A retirement is not abnormal unless the taxpayer can show that the withdrawal of the asset was not due to a cause which would customarily be contemplated (in light of the taxpayer's practice and experience) in setting a depreciation rate for the assets without regard to paragraph (a)(5)(ii) of this section. Thus, for example, a retirement is normal if made within the range of years which would customarily be taken into account in setting such depreciation rate and if the asset has reached a condition at which, in the normal course of events, the taxpayer customarily retires similar assets from use in his business. A retirement may be abnormal if the asset is withdrawn at an earlier time or under other circumstances, as, for example, when the asset has been damaged by casualty or has lost its usefulness suddenly as the result of extraordinary obsolescence.

(3) *Special rules*—(i) *In general.* The provisions of this subparagraph shall apply to qualified property in a taxable year for which an election to apply this section is made.

(ii) *Repairs.* For the purpose of sections 162 and 263 and the regulations thereunder, whether an expenditure prolongs the life of an asset shall be determined by reference to the expect-

ed period of use of the asset in the taxpayer's business without regard to paragraph (a)(5)(ii) of this section.

(iii) *Sale and lease.* For the purpose of comparison with the term of a lease of such property, the remaining life of qualified property shall be determined by reference to the expected period of use of the asset in the taxpayer's business without regard to paragraph (a)(5)(ii) of this section.

(4) *Expected period of use.* For the purposes of subparagraphs (2) and (3) of this paragraph, the determination of the expected period of use of an asset shall be made in light of all the facts and circumstances. The expected period of use of a particular asset will not necessarily coincide with the class life used for depreciation (or with the individual asset life for depreciation under the alternative method in paragraph (a)(5)(ii) (*b*) of this section for applying the class life). Thus, for example, if the question is whether an asset has been leased for a period less than, equal to or greater than its remaining life, the determination shall be based on the remaining expected period of use of the individual asset without regard to the fact that the asset is depreciated at a rate based on the class life in accordance with paragraph (a)(5)(ii)(*a*) of this section.

(5) *Leased property.* In the case of a lessor of qualified property, unless there is an asset guideline class in effect for such lessors, the asset guideline class for such property shall be determined by reference to the activity in which such property is primarily used by the lessee. See paragraph (b)(3) of this section for general rule for classification of qualified property according to primary use. However, in the case of an asset guideline class based upon the type of property (such as trucks or railroad cars), as distinguished from the activity in which used, the property shall be classified without regard to the activity of the lessee.

(e) *Election under this section*—(1) *Consent to change in method of accounting.* An election to apply this section for a taxable year ending after December 31, 1970, is a method of accounting but the consent of the Commissioner will be deemed granted to make an annual election.

(2) *Election for taxable years ending after December 31, 1976.* For taxable years ending after December 31, 1976, the election to apply this section for a taxable year shall be made by attaching to the income tax return a statement that an election under this section is being made. If the taxpayer does not file a timely return (taking into account extensions of time for filing) for the taxable year, the election shall be made at the time the taxpayer files his first return for the taxable year. The election may be made with an amended return only if such amended return is filed no later than the time prescribed by law (including extensions thereof) for filing the return for the taxable year. A taxpayer who makes an election under this subparagraph must maintain books and records reflecting the information described in paragraph (e)(3) (ii) and (iii) of this section.

(3) *Election for taxable years ending on or before December 31, 1976.* (i) For taxable years ending on or before December 31, 1976, the election to apply this section for a taxable year may be made by filing Form 5006 with the income tax return for the taxable year. If the taxpayer does not file a timely return (taking into account extensions of time for filing) for the taxable year, the election shall be filed at the time the taxpayer files his first return for the taxable year. The election may be made with an amended return only if such amended return is filed no later than the later of (*a*) the time prescribed by law (including extensions thereof) for filing the return for the taxable year, or (*b*) November 5, 1973.

(ii) The election to apply this section for a taxable year ending on or before December 31, 1976, will be deemed to be made if the tax return (filed within the periods referred to in paragraph (e)(3)(i) of this section) contains information sufficient to establish the following:

(*a*) Each asset guideline class for which the election is intended to apply;

(*b*) The class life for each such asset guideline class and whether the class

life is determined under paragraph (b)(1) or (2) of this section;

(c) For each asset guideline class, as of the end of the taxable year of election, (1) the total unadjusted basis of all qualified property, (2) the aggregate of the reserves for depreciation of all accounts in the asset guideline class, and (3) the aggregate of the salvage value established for all accounts in the asset guideline class; and

(d) Whether the taxpayer is an electric or gas utility using a composite asset guideline class basis in accordance with paragraph (b)(3)(iii) of this section.

If an election is deemed to to be made under this subdivision (ii), the taxpayer will be deemed to have consented to apply all the provisions of this section.

(iii) A taxpayer to whom the election applies shall maintain books and records for each asset guideline class reasonably sufficient to identify the unadjusted basis, reserve for depreciation and salvage value established for each depreciation account in such asset guidelines class.

(f) *Depreciation for taxable years ending before January 1, 1971*—(1) *Adoption of Revenue Procedure 62-21*—(i) *In general.* Except as provided in subdivision (ii) of this subparagraph, a taxpayer may elect to be examined under the provisions of Revenue Procedure 62-21 for a taxable year ending before January 1, 1971, only in accordance with the rules of this paragraph. The election must specify:

(a) That the taxpayer makes such election and consents to, and agrees to apply, all the provisions of this paragraph;

(b) Each guideline class and taxable year for which the taxpayer elects to be examined under Revenue Procedure 62-21;

(c) The class life claimed for each such guideline class;

(d) The class life and the total amount of the depreciation for the guideline class claimed on the last income tax return for such taxable year filed prior to January 12, 1971 (or in case no income tax return was filed prior to January 12, 1971, on the first income tax return filed for such taxable year);

(e) The class life claimed and the total amount of depreciation for the guideline class under the election to apply Revenue Procedure 62-21, in accordance with this paragraph, for the taxable year; and

(f) If the class life or total amount of depreciation for the guideline class is different in (d) and (e) of this subdivision, a reasonable description of the computation of the class life in (e) of this subdivision, the amount of difference in tax liability resulting therefrom, and the amount of any refund or reduction in any deficiency in tax. The election shall be made in an amended tax return or claim for refund (or by a supplement to the tax return or claim) for the taxable year, and if the class life or total amount of depreciation for the guideline class is different in accordance with (f) of this subdivision, such difference shall be reflected in the amended tax return or claim for refund. Forms may be provided for making the election and submission of the information. In the case of an election made after issuance of such forms and more than 30 days after publication of notice thereof in the Internal Revenue Bulletin, the election may be made and the information submitted only in accordance with such forms. An election will not otherwise be invalid under this paragraph so long as there is substantial compliance, in good faith, with the requirements of this paragraph.

(ii) *Special rule.* The provisions of this subparagraph shall not apply to a guideline class in any taxable year for which the taxpayer has prior to January 12, 1971, adopted Revenue Procedure 62-21 for such class. See subparagraph (2) of this paragraph for determination of adoption of Revenue Procedure 62-21 prior to January 12, 1971.

(iii) *Justification of class life claimed and limitations on refunds.* If the taxpayer elects for a taxable year to be examined under the provisions of Revenue Procedure 62-21 in accordance with subdivision (i) of this subparagraph, any of the provisions of Revenue Procedure 62-21 may be applied to justify a class life claimed on the income tax return filed for such year or to offset an increase in tax liability for such year. Unless it meets

the reserve ratio test, no class life will be accepted on audit which (after all other adjustments in tax liability for such year) results in a reduction (or further reduction) in the amount of tax liability shown on the income tax return (specified in subdivision (i)(*d*) of this subparagraph) for such taxable year, or results in an amount of loss carryback or carryover to any taxable year, but if it is justified under Revenue Procedure 62-21 and meets the reserve ratio test, a class life will be accepted on audit without regard to the foregoing limitations and, for example, may produce a refund or credit against tax. For example, if a class life of 9 years is otherwise justified under Revenue Procedure 62-21 for 1969, but the taxpayer does not meet the reserve ratio test for 1969 using a test life of 9 years, a class life of 9 years (or any class life justified under Revenue Procedure 62-21) will be accepted on audit under Revenue Procedure 62-21 pursuant to an election in accordance with this paragraph provided it does not result in the reduction or further reduction in tax liability or in an amount of loss carryback or carryover as described in the preceding sentence. On the other hand, for example, if a class life of 10 years is justified under Revenue Procedure 62-21 for 1969 and the taxpayer meets the reserve ratio test for 1969 using a test life of 10 years, a class life of 10 years will be accepted on audit under Revenue Procedure 62-21 pursuant to an election in accordance with this paragraph even though it results in a reduction or further reduction in tax liability or in an amount of loss carryback or carryover as described above and produces a refund of tax. For purposes of this section, the term "audit" includes examination of claims for refund or credit against tax.

(iv) *Definitions.* For purposes of this paragraph, the determination whether the reserve ratio test is met shall be made in accordance with that portion of paragraph (b)(2) of this section which is by express reference therein made applicable to this paragraph. In addition, the guideline form of the reserve ratio test, as described in Revenue Procedure 65-13, may be applied. * * * For purposes of this paragraph, references to Revenue Procedure 62-21 include all modifications, amendments, and supplements thereto as of January 11, 1971. The terms "class life" and "guideline class" have the same meaning as in Revenue Procedure 62-21.

(2) *Determination whether Revenue Procedure 62-21 adopted prior to January 12, 1971*—(i) *In general.* For the purposes of this paragraph, a taxpayer will be treated as having adopted prior to January 12, 1971, Revenue Procedure 62-21 for a guideline class for a taxable year ending before January 1, 1971, only if—

(*a*) For the guideline class and taxable year, the taxpayer adopted Revenue Procedure 62-21 by expressly so indicating on the income tax return filed for such taxable year prior to January 12, 1971;

(*b*) For the guideline class and taxable year, the taxpayer adopted Revenue Procedure 62-21 prior to January 12, 1971, by expressly so indicating in a proceeding before the Internal Revenue Service (such as upon examination of the income tax return for such taxable year) and there is reasonable evidence to that effect; or

(*c*) There is other reasonable evidence that prior to January 12, 1971, the taxpayer adopted Revenue Procedure 62-21 for the guideline class and taxable year.

If not treated under (*b*) or (*c*) of this subdivision as having done so for the last taxable year ending before January 1, 1971, and if the taxpayer files his first income tax return for such taxable year after January 11, 1971, the taxpayer will be treated as having adopted Revenue Procedure 62-21 prior to January 12, 1971, for a guideline class for such taxable year if he expressly so indicated on that return, or is treated under this subparagraph as having adopted Revenue Procedure 62-21 prior to January 12, 1971, for that guideline class for the immediately preceding taxable year.

(ii) *Examples.* The principles of this subparagraph may be illustrated by the following examples:

Example (1). Taxpayer A, an individual who uses the calendar year as his taxable year, has property in Group Three, Class

16(a), of Revenue Procedure 62-21. On A's income tax return for 1968, filed prior to January 12, 1971, he adopted Revenue Procedure 62-21 for the guideline class by so indicating under "Summary of Depreciation" in the appropriate schedule of Form 1040 for 1968. Under subdivision (i) (*a*) of this subparagraph, A is treated as having adopted Revenue Procedure 62-21 for the guideline class for 1968 prior to January 12, 1971.

Example (*2*). Taxpayer B, an individual who uses the calendar year as his taxable year, has property in Group Two, Class 5, of Revenue Procedure 62-21. B filed timely income tax returns for 1966 through 1968 but did not adopt Revenue Procedures 62-21 on any of such returns. In 1969 upon audit of B's taxable years 1966 through 1968, B exercised his option to be examined under the provisions of Revenue Procedure 62-21. The Revenue Agent's report shows that B was examined under Revenue Procedure 62-21 for taxable years 1966 through 1968. B will be treated under subdivision (ii)(*b*) of this subparagraph as having adopted Revenue Procedure 62-21 for such years prior to January 12, 1971.

Example (*3*). The facts are the same as in example (2) except that B did not upon examination by the Revenue Agent in 1969 exercise his option to be examined under Revenue Procedure 62-21. B has six accounts in the guideline class, Nos. 1 through 6. The Revenue Agent proposed to lengthen the depreciable lives on accounts Nos. 2 and 3 from 8 years to 12 years. In proceedings before the Appellate Division in 1970, B exercised his option to be examined under the provisions of Revenue Procedure 62-21. This is shown by correspondence between B and the Appellate Conferee as well as by other documents in the case before the Appellate Division. The case was settled on that basis before the Appellate Division without adjustment of the depreciable lives for B's accounts Nos. 2 and 3. B will be treated under subdivision (ii) (*b*) of this subparagraph as having adopted Revenue Procedure 62-21 for taxable years 1966 through 1968 prior to January 12, 1971.

Example (*4*). Corporation X uses the calendar year as its taxable year and has assets in Group Two, Class 5, of Revenue Procedure 62-21. Beginning in 1964, corporation X used the guideline life of 10 years as the depreciable life for all assets in the guideline class. In 1967, corporation X's taxable years 1964 through 1966 were examined and corporation X exercised its option to be examined under the provisions of Revenue Procedure 62-21. Corporation X did not adopt Revenue Procedure 62-21 on any of its income tax returns, for the years 1964 through 1970. Corporation X has not been examined since 1967, but has continued to use the guideline life of 10 years for all property in the guideline class including additions since 1966. Corporation X will be treated under subdivision (ii) (*c*) and (*d*) of this subparagraph as having adopted Revenue Procedure 62-21 prior to January 12, 1971, for taxable years 1964 through 1970.

Example (*5*). Corporation Y uses the calendar year as its taxable year and has asset in Group Two, Class 5, of Revenue Procedure 62-21. Since 1964, corporation Y has used various depreciable lives, based on the facts and circumstances, for different accounts in the guideline class. Corporation Y was examined in 1968 for taxable years 1965 through 1967. Corporation Y was also examined in 1970 for taxable years 1968 and 1969. Corporation Y did not exercise its option to be examined under the provisions of Revenue Procedure 62-21. Corporation Y has not adopted Revenue Procedure 62-21 on any income tax return. For taxable years 1964 through 1970, corporation Y's class life (within the meaning of section 4, Part II, of Revenue Procedure 62-21) was between 12 and 14 years. In August of 1971, corporation Y filed amended income tax returns for 1968 and 1969, and an income tax return for 1970, using a depreciable life of 10 years (equal to the guideline life) for all assets in the guideline class. Corporation Y will not be treated as having adopted Revenue Procedure 62-21 prior to January 12, 1971.

Example (*6*). Corporation Z uses the calendar year as its taxable year and has assets in group 2, class 5, of Revenue Procedure 62-21. Corporation Z adopted Revenue Procedure 62-21 for this guideline class by expressly so indicating on its tax return for 1966, which was filed before January 12, 1971. Corporation Z computed its allowable depreciation for 1966 as if it adopted Revenue Procedure 62-21 for this guideline class for its taxable years 1962 through 1965, although it had earlier filed its tax returns for those years without regard to Revenue Procedure 62-21. The depreciation thus claimed in 1966 was less than what would have been allowable if corporation Z first adopted Revenue Procedure 62-21 in 1966. This was the result of certain accounts becoming fully depreciated through use of Revenue Procedure 62-21 in computing depreciation for 1962 through 1965. In addition, in deferred tax accounting procedures employed before January 12, 1971, for financial reporting purposes, corporation Z calculated its tax deferrals on the basis that it had adopted Revenue Procedure 62-21 for the years 1962 through 1965. Corporation Z will be treated under subdivision (i) (*c*) of this subparagraph as having adopted Revenue Procedure 62-21 for taxable years 1962 through 1965 prior to January 12, 1971.

[Sec. 167(m), 85 Stat. 508 (26 U.S.C. 167)]

[T.D. 7278, 38 FR 14923, June 7, 1973, as amended by T.D. 7315, 39 FR 20195, June 7, 1974; T.D. 7517, 42 FR 58934, Nov. 14, 1977]

§ 1.167(b)-0 Methods of computing depreciation.

(a) *In general.* Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. Generally, depreciation deductions so claimed will be changed only where there is a clear and convincing basis for a change.

(b) *Certain methods.* Methods previously found adequate to produce a reasonable allowance under the Internal Revenue Code of 1939 or prior revenue laws will, if used consistently by the taxpayer, continue to be acceptable under section 167(a). Examples of such methods which continue to be acceptable are the straight line method, the declining balance method with the rate limited to 150 percent of the applicable straight line rate, and under appropriate circumstances, the unit of production method. The methods described in section 167(b) and §§ 1.167(b)-1, 1.167(b)-2, 1.167(b)-3, and 1.167 (b)-4 shall be deemed to produce a reasonable allowance for depreciation except as limited under section 167(c) and § 1.167(c)-1. See also § 1.167(e)-1 for rules relating to change in method of computing depreciation.

(c) *Application of methods.* In the case of item accounts, any method which results in a reasonable allowance for depreciation may be selected for each item of property, but such method must thereafter be applied consistently to that particular item. In the case of group, classified, or composite accounts, any method may be selected for each account. Such method must be applied to that particular account consistently thereafter but need not necessarily be applied to acquisitions of similar property in the same or subsequent years, provided such acquisitions are set up in separate accounts. See, however, § 1.167(e)-1 and section 446 and the regulations thereunder, for rules relating to changes in the method of computing depreciation, and § 1.167(c)-1 for restriction on the use of certain methods. See also § 1.167(a)-7 for definition of account.

§ 1.167(b)-1 Straight line method.

(a) *In general.* Under the straight line method the cost or other basis of the property less its estimated salvage value is deductible in equal annual amounts over the period of the estimated useful life of the property. The allowance for depreciation for the taxable year is determined by dividing the adjusted basis of the property at the beginning of the taxable year, less salvage value, by the remaining useful life of the property at such time. For convenience, the allowance so determined may be reduced to a percentage or fraction. The straight line method may be used in determining a reasonable allowance for depreciation for any property which is subject to depreciation under section 167 and it shall be used in all cases where the taxpayer has not adopted a different acceptable method with respect to such property.

(b) *Illustrations.* The straight line method is illustrated by the following examples:

Example (1). Under the straight line method items may be depreciated separately:

Year and item	Cost or other basis less salaries	Useful life (years)	Depreciation allowable		
			1954	1955	1956
1954:					
Asset A	$1,600	4	[1] $200	$400	$400
Asset B	12,000	40	[1] 150	300	300

[1] In this example it is assumed that the assets were placed in service on July 1, 1954.

Example (2). In group, classified, or composite accounting, a number of assets with the same or different useful lives may be combined into one account, and a single rate of depreciation, i.e., the group, classified, or composite rate used for the entire account. In the case of group accounts, i.e., accounts containing assets which are similar in kind and which have approximately the same estimated useful lives, the group rate is determined from the average of the useful lives of the assets. In the case of classified or composite accounts, the classified or composite rate is generally computed by determining the amount of one year's depreciation for each item or each group of similar items, and by dividing the total depreciation thus obtained by the total cost or other basis of the assets. The average rate so obtained is to be used as long as subsequent additions, retirements, or replacements do not substantially alter the relative proportions of different types of assets in the account. An example of the computation of a classified or composite rate follows:

Cost or other basis	Estimated useful life (years)	Annual depreciation
$10,000	5	$2,000
10,000	15	667
20,000		2,667

Average rate is 13.33 percent ($2,667÷$20,000) unadjusted for salvage. Assuming the estimated salvage value is 10 percent of the cost or other basis, the rate adjusted for salvage will be 13.33 percent minus 10 percent of 13.33 percent (13.33%−1.33%), or 12 percent.

Example (3). The use of the straight line method for group, classified, or composite accounts is illustrated by the following example: A taxpayer filing his returns on a calendar year basis maintains an asset account for which a group rate of 20 percent has been determined, before adjustment for salvage. Estimated salvage is determined to be 6⅔ percent, resulting in an adjusted rate of 18.67 percent. During the years illustrated, the initial investment, additions, retirements, and salvage recoveries, which were determined not to change the composition of the group sufficiently to require a change in rate, were assumed to have been made as follows:

1954—Initial investment of $12,000.

1957—Retirement $2,000, salvage realized $200.

1958—Retirement $2,000, salvage realized $200.

1959—Retirement $4,000, salvage realized $400.

1959—Additions $10,000.

1960—Retirement $2,000, no salvage realized.

1961—Retirement $2,000, no salvage realized.

DEPRECIABLE ASSET ACCOUNT AND DEPRECIATION COMPUTATION ON AVERAGE BALANCES

Year	Asset balance Jan. 1	Current additions	Current retirements	Asset balance Dec. 31	Average balance	Rate (percent)	Allowable depreciation
1954		$12,000		$12,000	$6,000	18.67	$1,120
1955	$12,000			12,000	12,000	18.67	2,240
1956	12,000			12,000	12,000	18.67	2,240
1957	12,000		$2,000	10,000	11,000	18.67	2,054
1958	10,000		2,000	8,000	9,000	18.67	1,680
1959	8,000	10,000	4,000	14,000	11,000	18.67	2,054
1960	14,000		2,000	12,000	13,000	18.67	2,427
1961	12,000		2,000	10,000	11,000	18.67	2,054

CORRESPONDING DEPRECIATION RESERVE ACCOUNT

Year	Depreciation reserve Jan. 1	Depreciation allowable	Current retirements	Salvage realized	Depreciation reserve Dec. 31
1954		$1,120			$1,120
1955	$1,120	2,240			3,360
1956	3,360	2,240			5,600
1957	5,600	2,054	$2,000	$200	5,854
1958	5,854	1,680	2,000	200	5,734
1959	5,734	2,054	4,000	400	4,188
1960	4,188	2,427	2,000		4,615
1961	4,615	2,054	2,000		4,669

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§ 1.167(b)-2 Declining balance method.

(a) *Application of method.* Under the declining balance method a uniform rate is applied each year to the unrecovered cost or other basis of the property. The unrecovered cost or other basis is the basis provided by section 167(g), adjusted for depreciation previously allowed or allowable, and for all other adjustments provided by section 1016 and other applicable provisions of law. The declining balance rate may be determined without resort to formula. Such rate determined under section 167(b)(2) shall not exceed twice the appropriate straight line rate computed without adjustment for salvage. While salvage is not taken into account in determining the annual allowances under this method, in no event shall an asset (or an account) be depreciated below a reasonable salvage value. However, see section 167(f) and § 1.167(f)-1 for rules which permit a reduction in the amount of salvage value to be taken into account for certain personal property acquired after October 16, 1962. Also, see section 167(c) and § 1.167(c)-1 for restrictions on the use of the declining balance method.

(b) *Illustrations.* The declining balance method is illustrated by the following examples:

Example (1). A new asset having an estimated useful life of 20 years was purchased on January 1, 1954, for $1,000. The normal straight line rate (without adjustment for salvage) is 5 percent, and the declining balance rate at twice the normal straight line rate is 10 percent. The annual depreciation allowances for 1954, 1955, and 1956 are as follows:

Year	Basis	Declining balance rate (percent)	Depreciation allowance
1954	$1,000	10	$100
1955	900	10	90
1956	810	10	81

Example (2). A taxpayer filing his returns on a calendar year basis maintains a group account to which a 5 year life and a 40 percent declining balance rate are applicable. Original investment, additions, retirements, and salvage recoveries are the same as those set forth in example (3) of paragraph (b) of § 1.167(b)-1. Although salvage value is not taken into consideration in computing a declining balance rate, it must be recognized and accounted for when assets are retired.

DEPRECIABLE ASSET ACCOUNT AND DEPRECIATION COMPUTATION USING AVERAGE ASSET AND RESERVE BALANCES

Year	Asset balance Jan. 1	Current additions	Current retirements	Asset balance Dec. 31	Average	Average reserve before depreciation	Net depreciable balance	Rate (pct.)	Allowable depreciation
1954		$12,000		$12,000	$6,000		$6,000	40	$2,400
1955	$12,000			12,000	12,000	$2,400	9,600	40	3,840
1956	12,000			12,000	12,000	6,240	5,760	40	2,304
1957	12,000		$2,000	10,000	11,000	7,644	3,356	40	1,342
1958	10,000		2,000	8,000	9,000	7,186	1,814	40	726
1959	8,000	10,000	4,000	14,000	11,000	5,212	5,788	40	2,315
1960	14,000		2,000	12,000	13,000	4,727	8,273	40	3,309
1961	12,000		2,000	10,000	11,000	6,036	4,964	40	1,986

DEPRECIATION RESERVE

Year	Reserve Jan. 1	Current retirements	Salvage realized	Reserve Dec. 31, before depreciation	Average reserve before depreciation	Allowable depreciation	Reserve Dec. 31, after depreciation
1954						$2,400	$2,400
1955	$2,400			$2,400	$2,400	3,840	6,240
1956	6,240			6,240	6,240	2,304	8,544
1957	8,544	$2,000	$200	6,744	7,644	1,342	8,086
1958	8,086	2,000	200	6,286	7,186	726	7,012
1959	7,012	4,000	400	3,412	5,212	2,315	5,727
1960	5,727	2,000		3,727	4,727	3,309	7,036
1961	7,036	2,000		5,036	6,036	1,986	7,022

Where separate depreciation accounts are maintained by year of acquisition and there is an unrecovered balance at the time of the last retirement, such unrecovered balance may be deducted as part of the depreciation allowance for the year of such retirement. Thus, if the taxpayer had kept separate depreciation accounts by year of acquisition and all the retirements shown in the example above were from 1954 acquisitions, depreciation would be computed on the 1954 and 1959 acquisitions as follows:

1954 ACQUISITIONS

Year	Asset balance Jan. 1	Acquisitions	Current retirements	Asset balance Dec. 31	Average balance	Avg. reserve before depreciation	Net depreciable balance	Rate (percent)	Allowable depreciation
1954		$12,000		$12,000	$6,000		$6,000	40	$2,400
1955	$12,000			12,000	12,000	$2,400	9,600	40	3,840
1956	12,000			12,000	12,000	6,240	5,760	40	2,304
1957	12,000		$2,000	10,000	11,000	7,644	3,356	40	1,342
1958	10,000		2,000	8,000	9,000	7,186	1,814	40	726
1959	8,000		4,000	4,000	6,000	5,212	788	40	315
1960	4,000		2,000	2,000	3,000	2,727	273	40	109
1961	2,000		2,000		1,000	836	164		[1] 164

[1] Balance allowable as depreciation in the year of retirement of the last survivor of the 1954 acquisitions.

DEPRECIATION RESERVE FOR 1954 ACQUISITIONS

Year	Reserve Jan. 1	Current retirements	Salvage realized	Reserve Dec. 31, before depreciation	Average reserve before depreciation	Allowable depreciation	Reserve Dec. 31, after depreciation
1954						$2,400	$2,400
1955	$2,400			$2,400	$2,400	3,840	6,240
1956	6,240			6,240	6,240	2,304	8,544
1957	8,544	$2,000	$200	6,744	7,644	1,342	8,086
1958	8,086	2,000	200	6,286	7,186	726	7,012
1959	7,012	4,000	400	3,412	5,212	315	3,727
1960	3,727	2,000		1,727	2,727	109	1,836
1961	1,836	2,000		(164)	836	164	

1959 ACQUISITIONS

Year	Asset balance Jan. 1	Acquisition	Asset balance Dec. 31	Avg. balance	Reserve Dec. 31, before depreciation	Net depreciable balance	Rate percent	Allowable depreciation	Reserve Dec. 31, after depreciation
1959		$10,000	$10,000	$5,000	None	$5,000	40	$2,000	$2,000
1960	$10,000		10,000	10,000	$2,000	8,000	40	3,200	5,200
1961	10,000		10,000	10,000	5,200	4,800	40	1,920	7,120

In the above example, the allowable depreciation on the 1954 acquisitions totals $11,200. This amount when increased by salvage realized in the amount of $800, equals the entire cost or other basis of the 1954 acquisitions ($12,000).

(c) *Change in estimated useful life.* In the declining balance method when a change is justified in the useful life estimated for an account, subsequent computations shall be made as though the revised useful life had been originally estimated. For example, assume that an account has an estimated useful life of ten years and that a declining balance rate of 20 percent is applicable. If, at the end of the sixth year, it is determined that the remaining useful life of the account is six years, computations shall be made as though the estimated useful life was originally determined as twelve years. Accordingly, the applicable depreciation rate will be 16⅔ percent. This rate is thereafter applied to the unrecovered cost or other basis.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3653, Mar. 24, 1964]

§ 1.167(b)-3 Sum of the years-digits method.

(a) *Applied to a single asset*—(1) *General rule.* Under the sum of the years-digits method annual allowances for depreciation are computed by applying changing fractions to the cost or other basis of the property reduced by estimated salvage. The numerator of the fraction changes each year to a number which corresponds to the remaining useful life of the asset (including the year for which the allowance is being computed), and the denominator which remains constant is the sum of all the years digits corresponding to the estimated useful life of the asset. See section 167(c) and § 1.167(c)-1 for restrictions on the use of the sum of the years-digits method.

(i) *Illustrations.* Computation of depreciation allowances on a single asset under the sum of the years-digits method is illustrated by the following examples:

Example (1). A new asset having an estimated useful life of five years was acquired on January 1, 1954, for $1,750. The estimated salvage is $250. For a taxpayer filing his returns on a calendar year basis, the annual depreciation allowances are as follows:

Year	Cost or other basis less salvage	Fraction[1]	Allowable depreciation	Depreciation reserve
1954	$1,500	5/15	$500	$500
1955	1,500	4/15	400	900
1956	1,500	3/15	300	1,200
1957	1,500	2/15	200	1,400
1958	1,500	1/15	100	1,500
Unrecovered value (salvage)				$250

[1] The denominator of the fraction is the sum of the digits representing the years of useful life, i.e., 5, 4, 3, 2, and 1, or 15.

Example (2). Assume in connection with an asset acquired in 1954 that three-fourths of a year's depreciation is allowable in that year. The following illustrates a reasonable method of allocating depreciation:

	Depreciation for 12 months	Allowable depreciation		
		1954	1955	1956
1st year	$500	(¾) $375	(¼) $125	
2d year	400		(¾) 300	(¼) $100
3d year	300			(¾) 225
		375	425	325

(ii) *Change in useful life.* Where in the case of a single asset, a change is justified in the useful life, subsequent

computations shall be made as though the remaining useful life at the beginning of the taxable year of change were the useful life of a new asset acquired at such time and with a basis equal to the unrecovered cost or other basis of the asset at that time. For example, assume that a new asset with an estimated useful life of ten years is purchased in 1954. At the time of making out his return for 1959, the taxpayer finds that the asset has a remaining useful life of seven years from January 1, 1959. Depreciation for 1959 should then be computed as though 1959 were the first year of the life of an asset estimated to have a useful life of seven years, and the allowance for 1959 would be 7/28 of the unrecovered cost or other basis of the asset after adjustment for salvage.

(2) *Remaining life*—(i) *Application.* Under the sum of the years-digits method, annual allowances for depreciation may also be computed by applying changing fractions to the unrecovered cost or other basis of the asset reduced by estimated salvage. The numerator of the fraction changes each year to a number which corresponds to the remaining useful life of the asset (including the year for which the allowance is being computed), and the denominator changes each year to a number which represents the sum of the digits corresponding to the years of estimated remaining useful life of the asset. For decimal equivalents of such fractions, see Table I of subdivision (ii) of this subparagraph. For example, a new asset with an estimated useful life of 10 years is purchased January 1, 1954, for $6,000. Assuming a salvage value of $500, the depreciation allowance for 1954 is $1,000 ($5,500×0.1818, the applicable rate from Table I). For 1955, the unrecovered balance is $4,500, and the remaining life is 9 years. The depreciation allowance for 1955 would then be $900 ($4,500×0.2000, the applicable rate from Table I).

(ii) *Table I.* This table shows decimal equivalents of sum of the years-digits fractions corresponding to remaining lives from 1 to 100 years.

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE

Remaining life (years)	Decimal equivalent
100.0	0.0198
99.9	.0198
99.8	.0198
99.7	.0199
99.6	.0199
99.5	.0199
99.4	.0199
99.3	.0199
99.2	.0200
99.1	.0200
99.0	.0200
98.9	.0200
98.8	.0200
98.7	.0201
98.6	.0201
98.5	.0201
98.4	.0201
98.3	.0201
98.2	.0202
98.1	.0202
98.0	.0202
97.9	.0202
97.8	.0202
97.7	.0203
97.6	.0203
97.5	.0203
97.4	.0203
97.3	.0203
97.2	.0204
97.1	.0204
97.0	.0204
96.9	.0204
96.8	.0204
96.7	.0205
96.6	.0205
96.5	.0205
96.4	.0205
96.3	.0206
96.2	.020
96.1	.020
96.0	.020
95.9	.0206
95.8	.0207
95.7	.0207
95.6	.0207
95.5	.0207
95.4	.0207
95.3	.0208
95.2	.0208
95.1	.0208
95.0	.0208
94.9	.0209
94.8	.0209
94.7	.0209
94.6	.0209
94.5	.020
94.4	.0210
94.3	.0210
94.2	.0210
94.1	.021
94.0	.0211
93.9	.0211
93.8	.0211
93.7	.0211
93.6	.0211
93.5	.0212

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
93.4	.0212
93.3	.0212
93.2	.0212
93.1	.0213
93.0	.0213
92.9	.0213
92.8	.0213
92.7	.0213
92.6	.0214
92.5	.0214
92.4	.0214
92.3	.0214
92.2	.0215
92.1	.0215
92.0	.0215
91.9	.0215
91.8	.0216
91.7	.0216
91.6	.0216
91.5	.0216
91.4	.0216
91.3	.0217
91.2	.0217
91.1	.0217
91.0	.0217
90.9	.0218
90.8	.0218
90.7	.0218
90.6	.0218
90.5	.0219
90.4	.0219
90.3	.0219
90.2	.0219
90.1	.0220
90.0	.0220
89.9	.0220
89.8	.0220
89.7	.0221
89.6	.0221
89.5	.0221
89.4	.0221
89.3	.0221
89.2	.0222
89.1	.0222
89.0	.0222
88.9	.0222
88.8	.0223
88.7	.0223
88.6	.0223
88.5	.0223
88.4	.0224
88.3	.0224
88.2	.0224
88.1	.0224
88.0	.0225
87.9	.0225
87.8	.0225
87.7	.0225
87.6	.0226
87.5	.0226
87.4	.0226
87.3	.0226
87.2	.0227
87.1	.0227
87.0	.0227
86.9	.0228

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
86.8	.0228
86.7	.0228
86.6	.0228
86.5	.0229
86.4	.0229
86.3	.0229
86.2	.0229
86.1	.0230
86.0	.0230
85.9	.0230
85.8	.0230
85.7	.0231
85.6	.0231
85.5	.0231
85.4	.0231
85.3	.0232
85.2	.0232
85.1	.0232
85.0	.0233
84.9	.0233
84.8	.0233
84.7	.0233
84.6	.0234
84.5	.0234
84.4	.0234
84.3	.0234
84.2	.0235
84.1	.0235
84.0	.0235
83.9	.0236
83.8	.0236
83.7	.0236
83.6	.0236
83.5	.0237
83.4	.0237
83.3	.0237
83.2	.0238
83.1	.0238
83.0	.0238
82.9	.0238
82.8	.0239
82.7	.0239
82.6	.0239
82.5	.0240
82.4	.0240
82.3	.0240
82.2	.0240
82.1	.0241
82.0	.0241
81.9	.0241
81.8	.0242
81.7	.0242
81.6	.0242
81.5	.0242
81.4	.0243
81.3	.0243
81.2	.0243
81.1	.0244
81.0	.0244
80.9	.0244
80.8	.0244
80.7	.0245
80.6	.0245
80.5	.0245
80.4	.0246
80.3	.0246

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
80.2	.0246
80.1	.0247
80.0	.0247
79.9	.0247
79.8	.0248
79.7	.0248
79.6	.0248
79.5	.0248
79.4	.0249
79.3	.0249
79.2	.0249
79.1	.0250
79.0	.0250
78.9	.0250
78.8	.0251
78.7	.0251
78.6	.0251
78.5	.0252
78.4	.0252
78.3	.0252
78.2	.0253
78.1	.0253
78.0	.0253
77.9	.0253
77.8	.0254
77.7	.0254
77.6	.0254
77.5	.0255
77.4	.0255
77.3	.0255
77.2	.0256
77.1	.0256
77.0	.0256
76.9	.0257
76.8	.0257
76.7	.0257
76.6	.0258
76.5	.0258
76.4	.0258
76.3	.0259
76.2	.0259
76.1	.0259
76.0	.0260
75.9	.0260
75.8	.0260
75.7	.0261
75.6	.0261
75.5	.0261
75.4	.0262
75.3	.0262
75.2	.0262
75.1	.0263
75.0	.0263
74.9	.0264
74.8	.0264
74.7	.0264
74.6	.0265
74.5	.0265
74.4	.0265
74.3	.0266
74.2	.0266
74.1	.0266
74.0	.0267
73.9	.0267
73.8	.0267
73.7	.0268

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
73.6	.0268
73.5	.0268
73.4	.0269
73.3	.0269
73.2	.0270
73.1	.0270
73.0	.0270
72.9	.0271
72.8	.0271
72.7	.0271
72.6	.0272
72.5	.0272
72.4	.0272
72.3	.0273
72.2	.0273
72.1	.0274
72.0	.0274
71.9	.0274
71.8	.0275
71.7	.0275
71.6	.0275
71.5	.0276
71.4	.0276
71.3	.0277
71.2	.0277
71.1	.0277
71.0	.0278
70.9	.0278
70.8	.0279
70.7	.0279
70.6	.0279
70.5	.0280
70.4	.0280
70.3	.0280
70.2	.0281
70.1	.0281
70.0	.0282
69.9	.0282
69.8	.0282
69.7	.0283
69.6	.0283
69.5	.0284
69.4	.0284
69.3	.0284
69.2	.0285
69.1	.0285
69.0	.0286
68.9	.0286
68.8	.0287
68.7	.0287
68.6	.0287
68.5	.0288
68.4	.0288
68.3	.0289
68.2	.0289
68.1	.0289
68.0	.0290
67.9	.0290
67.8	.0291
67.7	.0291
67.6	.0292
67.5	.0292
67.4	.0292
67.3	.0293
67.2	.0293
67.1	.0294

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
67.0	.0294
66.9	.0295
66.8	.0295
66.7	.0295
66.6	.0296
66.5	.0296
66.4	.0297
66.3	.0297
66.2	.0298
66.1	.0298
66.0	.0299
65.9	.0299
65.8	.0299
65.7	.0300
65.6	.0300
65.5	.0301
65.4	.0301
65.3	.0302
65.2	.0302
65.1	.0303
65.0	.0303
64.9	.0303
64.8	.0304
64.7	.0304
64.6	.0305
64.5	.0305
64.4	.0306
64.3	.0306
64.2	.0307
64.1	.0307
64.0	.0308
63.9	.0308
63.8	.0309
63.7	.0309
63.6	.0310
63.5	.0310
63.4	.0311
63.3	.0311
63.2	.0312
63.1	.0312
63.0	.0313
62.9	.0313
62.8	.0313
62.7	.0314
62.6	.0314
62.5	.0315
62.4	.0315
62.3	.0316
62.2	.0316
62.1	.0317
62.0	.0317
61.9	.0318
61.8	.0318
61.7	.0319
61.6	.0319
61.5	.0320
61.4	.0320
61.3	.0321
61.2	.0322
61.1	.0322
61.0	.0323
60.9	.0323
60.8	.0324
60.7	.0324
60.6	.0325
60.5	.0325

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
60.4	.0326
60.3	.0326
60.2	.0327
60.1	.0327
60.0	.0328
59.9	.0328
59.8	.0329
59.7	.0329
59.6	.0330
59.5	.0331
59.4	.0331
59.3	.0332
59.2	.0332
59.1	.0333
59.0	.0333
58.9	.0334
58.8	.0334
58.7	.0335
58.6	.0336
58.5	.0336
58.4	.0337
58.3	.0337
58.2	.0338
58.1	.0338
58.0	.0339
57.9	.0340
57.8	.0340
57.7	.0341
57.6	.0341
57.5	.0342
57.4	.0342
57.3	.0343
57.2	.0344
57.1	.0344
57.0	.0345
56.9	.0345
56.8	.0346
56.7	.0347
56.6	.0347
56.5	.0348
56.4	.0348
56.3	.0349
56.2	.0350
56.1	.0350
56.0	.0351
55.9	.0351
55.8	.0352
55.7	.0353
55.6	.0353
55.5	.0354
55.4	.0355
55.3	.0355
55.2	.0356
55.1	.0356
55.0	.0357
54.9	.0358
54.8	.0358
54.7	.0359
54.6	.0360
54.5	.0360
54.4	.0361
54.3	.0362
54.2	.0362
54.1	.0363
54.0	.0364
53.9	.0364

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
53.8	.0365
53.7	.0366
53.6	.0366
53.5	.0367
53.4	.0368
53.3	.0368
53.2	.0369
53.1	.0370
53.0	.0370
52.9	.0371
52.8	.0372
52.7	.0372
52.6	.0373
52.5	.0374
52.4	.0374
52.3	.0375
52.2	.0376
52.1	.0377
52.0	.0377
51.9	.0378
51.8	.0379
51.7	.0379
51.6	.0380
51.5	.0381
51.4	.0382
51.3	.0382
51.2	.0383
51.1	.0384
51.0	.0385
50.9	.0385
50.8	.0386
50.7	.0387
50.6	.0388
50.5	.0388
50.4	.0389
50.3	.0390
50.2	.0391
50.1	.0391
50.0	.0392
49.9	.0393
49.8	.0394
49.7	.0394
49.6	.0395
49.5	.0396
49.4	.0397
49.3	.0398
49.2	.0398
49.1	.0399
49.0	.0400
48.9	.0401
48.8	.0402
48.7	.0402
48.6	.0403
48.5	.0404
48.4	.0405
48.3	.0406
48.2	.0406
48.1	.0407
48.0	.0408
47.9	.0409
47.8	.0410
47.7	.0411
47.6	.0411
47.5	.0412
47.4	.0413
47.3	.0414

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
47.2	.0415
47.1	.0416
47.0	.0417
46.9	.0418
46.8	.0418
46.7	.0419
46.6	.0420
46.5	.0421
46.4	.0422
46.3	.0423
46.2	.0424
46.1	.0425
46.0	.0426
45.9	.0426
45.8	.0427
45.7	.0428
45.6	.0429
45.5	.0430
45.4	.0431
45.3	.0432
45.2	.0433
45.1	.0434
45.0	.0435
44.9	.0436
44.8	.0437
44.7	.0438
44.6	.0439
44.5	.0440
44.4	.0440
44.3	.0441
44.2	.0442
44.1	.0443
44.0	.0444
43.9	.0445
43.8	.0446
43.7	.0447
43.6	.0448
43.5	.0449
43.4	.0450
43.3	.0451
43.2	.0452
43.1	.0453
43.0	.0455
42.9	.0456
42.8	.0457
42.7	.0458
42.6	.0459
42.5	.0460
42.4	.0461
42.3	.0462
42.2	.0463
42.1	.0464
42.0	.0465
41.9	.0466
41.8	.0467
41.7	.0468
41.6	.0469
41.5	.0471
41.4	.0472
41.3	.0473
41.2	.0474
41.1	.0475
41.0	.0476
40.9	.0477
40.8	.0478
40.7	.0480

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
40.6	.0481
40.5	.0482
40.4	.0483
40.3	.0484
40.2	.0485
40.1	.0487
40.0	.0488
39.9	.0489
39.8	.0490
39.7	.0491
39.6	.0493
39.5	.0494
39.4	.0495
39.3	.0496
39.2	.0497
39.1	.0499
39.0	.0500
38.9	.0501
38.8	.0502
38.7	.0504
38.6	.0505
38.5	.0506
38.4	.0508
38.3	.0509
38.2	.0510
38.1	.0511
38.0	.0513
37.9	.0514
37.8	.0515
37.7	.0517
37.6	.0518
37.5	.0519
37.4	.0521
37.3	.0522
37.2	.0524
37.1	.0525
37.0	.0526
36.9	.0528
36.8	.0529
36.7	.0530
36.6	.0532
36.5	.0533
36.4	.0525
36.3	.0536
36.2	.0538
36.1	.0539
36.0	.0541
35.9	.0542
35.8	.0543
35.7	.0545
35.6	.0546
35.5	.0548
35.4	.0549
35.3	.0551
35.2	.0552
35.1	.0554
35.0	.0556
34.9	.0557
34.8	.0559
34.7	.0560
34.6	.0562
34.5	.0563
34.4	.0565
34.3	.0566
34.2	.0566
34.1	.0570

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
34.0	.0571
33.9	.0573
33.8	.0575
33.7	.0576
33.6	.0578
33.5	.0580
33.4	.0581
33.3	.0583
33.2	.0585
33.1	.0586
33.0	.0588
32.9	.0590
32.8	.0592
32.7	.0593
32.6	.0595
32.5	.0597
32.4	.0599
32.3	.0600
32.2	.0602
32.1	.0604
32.0	.0606
31.9	.0608
31.8	.0610
31.7	.0611
31.6	.0613
31.5	.0615
31.4	.0617
31.3	.0619
31.2	.0621
31.1	.0623
31.0	.0625
30.9	.0627
30.8	.0629
30.7	.0631
30.6	.0633
30.5	.0635
30.4	.0637
30.3	.0639
30.2	.0641
30.1	.0643
30.0	.0645
29.9	.0647
29.8	.0649
29.7	.0651
29.6	.0653
29.5	.0656
29.4	.0658
29.3	.0660
29.2	.0662
29.1	.0664
29.0	.0667
28.9	.0669
28.8	.0671
28.7	.0673
28.6	.0675
28.5	.0678
28.4	.0680
28.3	.0682
28.2	.0685
28.1	.0687
28.0	.0690
27.9	.0692
27.8	.0694
27.7	.0697
27.6	.0699
27.5	.0702

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
27.4	.0704
27.3	.0707
27.2	.0709
27.1	.0712
27.0	.0714
26.9	.0717
26.8	.0719
26.7	.0722
26.6	.0724
26.5	.0727
26.4	.0730
26.3	.0732
26.2	.0735
26.1	.0738
26.0	.0741
25.9	.0743
25.8	.0746
25.7	.0749
25.6	.0752
25.5	.0754
25.4	.0757
25.3	.0760
25.2	.0763
25.1	.0766
25.0	.0769
24.9	.0772
24.8	.0775
24.7	.0778
24.6	.0781
24.5	.0784
24.4	.0787
24.3	.0790
24.2	.0793
24.1	.0797
24.0	.0800
23.9	.0803
23.8	.0806
23.7	.0809
23.6	.0813
23.5	.0816
23.4	.0819
23.3	.0823
23.2	.0826
23.1	.0830
23.0	.0833
22.9	.0837
22.8	.0840
22.7	.0844
22.6	.0847
22.5	.0851
22.4	.0854
22.3	.0858
22.2	.0862
22.1	.0866
22.0	.0870
21.9	.0873
21.8	.0877
21.7	.0881
21.6	.0885
21.5	.0888
21.4	.0892
21.3	.0896
21.2	.0901
21.1	.0905
21.0	.0909
20.9	.0913

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
20.8	.0917
20.7	.0921
20.6	.0925
20.5	.0930
20.4	.0934
20.3	.0939
20.2	.0943
20.1	.0948
20.0	.0952
19.9	.0957
19.8	.0961
19.7	.0966
19.6	.0970
19.5	.0975
19.4	.0980
19.3	.0985
19.2	.0990
19.1	.0995
19.0	.1000
18.9	.1005
18.8	.1010
18.7	.1015
18.6	.1020
18.5	.1025
18.4	.1030
18.3	.1036
18.2	.1041
18.1	.1047
18.0	.1053
17.9	.1058
17.8	.1063
17.7	.1069
17.6	.1074
17.5	.1080
17.4	.1086
17.3	.1092
17.2	.1098
17.1	.1105
17.0	.1111
16.9	.1117
16.8	.1123
16.7	.1129
16.6	.1135
16.5	.1142
16.4	.1148
16.3	.1155
16.2	.1162
16.1	.1169
16.0	.1176
15.9	.1183
15.8	.1190
15.7	.1197
15.6	.1204
15.5	.1211
15.4	.1218
15.3	.1226
15.2	.1234
15.1	.1242
15.0	.1250
14.9	.1257
14.8	.1265
14.7	.1273
14.6	.1281
14.5	.1289
14.4	.1297
14.3	.1306

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
14.2	.1315
14.1	.1324
14.0	.1333
13.9	.1342
13.8	.1350
13.7	.1359
13.6	.1368
13.5	.1378
13.4	.1387
13.3	.1397
13.2	.1407
13.1	.1418
13.0	.1429
12.9	.1438
12.8	.1448
12.7	.1458
12.6	.1469
12.5	.1479
12.4	.1490
12.3	.1502
12.2	.1514
12.1	.1526
12.0	.1538
11.9	.1549
11.8	.1561
11.7	.1573
11.6	.1585
11.5	.1597
11.4	1610
11.3	.1624
11.2	.1637
11.1	.1652
11.0	.1667
10.9	.1680
10.8	.1693
10.7	.1707
10.6	.1721
10.5	.1736
10.4	.1751
10.3	.1767
10.2	.1783
10.1	.1800
10.0	.1818
9.9	.1833
9.8	.1849
9.7	.1865
9.6	.1882
9.5	.1900
9.4	.1918
9.3	.1938
9.2	.1957
9.1	.1978
9.0	.2000
8.9	.2018
8.8	.2037
8.7	.2057
8.6	.2077
8.5	.2099
8.4	.2121
8.3	.2145
8.2	.2169
8.1	.2195
8.0	.2222
7.9	.2244
7.8	.2267
7.7	.2292
7.6	.2317

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
7.5	.2344
7.4	.2372
7.3	.2401
7.2	.2432
7.1	.2465
7.0	.2500
6.9	.2527
6.8	.2556
6.7	.2587
6.6	.2619
6.5	.2653
6.4	.2689
6.3	.2727
6.2	.2768
6.1	.2811
6.0	.2857
5.9	.2892
5.8	.2929
5.7	.2969
5.6	.3011
5.5	.3056
5.4	.3103
5.3	.3155
5.2	.3210
5.1	.3269
5.0	.3333
4.9	.3379
4.8	.3429
4.7	.3481
4.6	.3538
4.5	.3600
4.4	.3667
4.3	.3739
4.2	.3818
4.1	.3905
4.0	.4000
3.9	.4063
3.8	.4130
3.7	.4205
3.6	.4286
3.5	.4375
3.4	.4474
3.3	.4583
3.2	.4706
3.1	.4844
3.0	.5000
2.9	.5088
2.8	.5185
2.7	.5294
2.6	.5417
2.5	.5556
2.4	.5714
2.3	.5897
2.2	.6111
2.1	.6364
2.0	.6667
1.9	.6786
1.8	.6923
1.7	.7083
1.6	.7273
1.5	.7500
1.4	.7778
1.3	.8125
1.2	.8571
1.1	.9167
1.0	1.0000

NOTE: For determination of decimal equivalents of remaining lives falling between those shown in the above table, the taxpayer may use the next longest life shown in the table, interpolate from the table, or use the following formula from which the table was derived.

$$D=2R/(W+2F)(W+1)$$

where:
D=Decimal equivalent.
R=Remaining life.
W=Whole number of years in remaining life.
F=Fractional part of a year in remaining life.

If the taxpayer desires to carry his calculations of decimal equivalents to a greater number of decimal places than is provided in the table, he may use the formula. The procedure adopted must be consistently followed thereafter.

(b) *Applied to group, classified, or composite accounts*—(1) *General rule.* The sum of the years-digits method may be applied to group, classified, or composite accounts in accordance with the plan described in subparagraph (2) of this paragraph or in accordance with other plans as explained in subparagraph (3) of this paragraph.

(2) *Remaining life plan.* The remaining life plan as applied to a single asset is described in paragraph (a)(2) of this section. This plan may also be applied to group, classified, or composite accounts. Under this plan the allowance for depreciation is computed by applying changing fractions to the unrecovered cost or other basis of the account reduced by estimated salvage. The numerator of the fraction changes each year to a number which corresponds to the remaining useful life of the account (including the year for which the allowance is being computed), and the denominator changes each year to a number which represents the sum of the years digits corresponding to the years of estimated remaining useful life of the account. Decimal equivalents of such fractions can be obtained by use of Table I under paragraph (a)(2)(ii) of this section. The proper application of this method requires that the estimated remaining useful life of the account be determined each year. This determination, of course, may be made each year by analysis, i.e., by determining the remaining lives for each of the components in the account, and averaging them. The estimated remaining life of any account, however, may also be determined arithmetically. For example, it may be computed by dividing the unrecovered cost or other basis of the account, as computed by straight line depreciation, by the gross cost or other basis of the account, and multiplying the result by the average life of the assets in the account. Salvage value is not a factor for the purpose of determining remaining life. Thus, if a group account with an average life of ten years had at January 1, 1958, a gross asset balance of $12,600 and a depreciation reserve computed on the straight line method of $9,450, the remaining life of the account at January 1, 1958, would be computed as follows:

$12,600-$9,450÷$12,600×10 years equals 2.50 years.

Example. The use of the sum of the years-digits method with group, classified, or composite accounts under the remaining life plan is illustrated by the following example:

A calendar year taxpayer maintains a group account to which a five-year life is applicable. Original investment, additions, retirements, and salvage recoveries are the same as those set forth in example (3) of paragraph (b) of § 1.167(b)-1.

DEPRECIATION COMPUTATIONS ON A GROUP ACCOUNT UNDER REMAINING LIFE PLAN

	1	2	3	4	5	6	7	8	9	10	11	12	13	14
											Sum of the years digits depreciation			
Year	Asset balance Jan. 1	Current additions	Current retirements	Average asset balance	Straight line amount Col. (4) ÷ life	Straight line reserve Col. (5) – Col. (3) accumulated Jan. 1	Remaining life [Col. (1) – Col. (6) ÷ Col. (1)] × average service life	Asset balance reduced by salvage Col. (1) × (100% – 6.67%)	Current additions reduced by salvage Col (2) × (100% – 6.67%)	Salvage realized	Accumulated reserve Jan. 1 Prior reserve + Col. (14) + Col. (10) – Col. (3)	Unrecovered Jan. 1 Col. (8) – Col. (11)	Rate based on Col. (7) from Table 1	Allowable depreciation Col. (12) × Col. (13) + ½ Col. (9) × F[2]
1954		$12,000		$6,000	[1] $1,200		5.00		$11,200				0.3333	$1,866
1955	$12,000			12,000	2,400	$1,200	4.50	$11,200			$1,866	$9,334	.3600	3,360
1956	12,000			12,000	2,400	3,600	3.50	11,200			5,226	5,974	.4375	2,614
1957	12,000		$2,000	11,000	2,200	6,000	2.50	11,200		$200	7,840	3,360	.5556	1,867
1958	10,000		2,000	9,000	1,800	6,200	1.90	9,333		200	7,907	1,426	.6786	968
1959	8,000	10,000	4,000	11,000	2,200	6,000	1.25	7,466	9,333	400	7,075	391	.8125	1,874
1960	14,000		2,000	13,000	2,600	4,200	3.50	13,066			5,349	7,717	.4375	3,376
1961	12,000		2,000	11,000	2,200	4,800	3.00	11,200			6,725	4,475	.5000	2,238
1962						5,000					6,963			

[1] ½ year's amount.
[2] F = Rate based on average service life (0.3333 in this example).

(3) *Other plans for application of the sum of the years-digits method.* Taxpayers who wish to use the sum of the years-digits method in computing depreciation for group, classified, or composite accounts in accordance with a sum of the years digits plan other than the remaining life plan described herein may do so only with the consent of the Commissioner. Request for permission to use plans other than that described shall be addressed to the Commissioner of Internal Revenue, Washington, D.C. 20224.

§ 1.167(b)-4 Other methods.

(a) Under section 167(b)(4) a taxpayer may use any consistent method of computing depreciation, such as the sinking fund method, provided depreciation allowances computed in accordance with such method do not result in accumulated allowances at the end of any taxable year greater than the total of the accumulated allowances which could have resulted from the use of the declining balance method described in section 167(b)(2). This limitation applies only during the first two-thirds of the useful life of the property. For example, an asset costing $1,000 having a useful life of six years may be depreciated under the declining balance method in accordance with § 1.167(b)-2, at a rate of 33⅓ percent. During the first four years or ⅔ of its useful life, maximum depreciation allowances under the declining balance method would be as follows:

	Current depreciation	Accumulated depreciation	Balance
Cost of asset			$1,000
First year	$333	$333	667
Second year	222	555	445
Third year	148	703	297
Fourth year	99	802	198

An annual allowance computed by any other method under section 167(b)(4) could not exceed $333 for the first year, and at the end of the second year the total allowances for the two years could not exceed $555. Likewise, the total allowances for the three years could not exceed $703 and for the four years could not exceed $802. This limitation would not apply in the fifth and sixth years. See section 167(c) and § 1.167(c)-1 for restriction on the use of certain methods.

(b) It shall be the responsibility of the taxpayer to establish to the satisfaction of the Commissioner that a method of depreciation under section 167(b)(4) is both a reasonable and consistent method and that it does not produce depreciation allowances in excess of the amount permitted under the limitations provided in such section.

§ 1.167(c)-1 Limitations on methods of computing depreciation under section 167(b) (2), (3), and (4).

(a) *In general.* (1) Section 167(c) provides limitations on the use of the declining balance method described in section 167(b)(2), the sum of the years-digits method described in section 167(b)(3), and certain other methods authorized by section 167(b)(4). These methods are applicable only to tangible property having a useful life of three years or more. If construction, reconstruction, or erection by the taxpayer began before January 1, 1954, and was completed after December 31, 1953, these methods apply only to that portion of the basis of the property which is properly attributable to such construction, reconstruction, or erection after December 31, 1953. Property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications. The portion of the basis of such property attributable to construction, reconstruction, or erection after December 31, 1953, consists of all costs of the property allocable to the period after December 31, 1953, including the cost or other basis of materials entering into such work. It is not necessary that such materials be acquired after December 31, 1953, or that they be new in use. If construction or erection by the taxpayer began after December 31, 1953, the entire cost or other basis of such construction or erection qualifies for these methods of depreciation. In the case of reconstruction of property, these methods do not apply to any part of the adjusted basis of such

property on December 31, 1953. For purposes of this section, construction, reconstruction, or erection by the taxpayer begins when physical work is started on such construction, reconstruction, or erection.

(2) If the property was not constructed, reconstructed, or erected by the taxpayer, these methods apply only if it was acquired after December 31, 1953, and if the original use of the property commences with the taxpayer and commences after December 31, 1953. For the purpose of the preceding sentence, property shall be deemed to be acquired when reduced to physical possession, or control. The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. For example, a reconditioned or rebuilt machine acquired after December 31, 1953, will not be treated as being put to original use by the taxpayer even though it is put to a different use, nor will a horse acquired for breeding purposes be treated as being put to original use by the taxpayer if prior to the purchase the horse was used for racing purposes. See §§ 1.167(b)-2, 1.167 (b)-3, and 1.167(b)-4 for application of the various methods.

(3) Assets having an estimated average useful life of less than three years shall not be included in a group, classified, or composite account to which the methods described in §§ 1.167 (b)-2, 1.167(b)-3, and 1.167(b)-4 are applicable. However, an incidental retirement of an asset from such an account prior to the expiration of a useful life of three years will not prevent the application of these methods to such an account.

(4) See section 381(c)(6) and the regulations thereunder for rules covering the use of depreciation methods by acquiring corporations in the case of certain corporate acquisitions.

(5) See §§ 1.1502-12(g) and 1.1502-31 for provisions dealing with depreciation of property received by a member of an affiliated group from another member of the group during a consolidated return period.

(6) Except in the cases described in subparagraphs (4) and (5) of this paragraph, the methods of depreciation described in §§ 1.167(b)-2, 1.167(b-(3), and 1.167(b)-4 are not applicable to property in the hands of a distributee, vendee, transferee, donee, or grantee unless the original use of the property begins with such person and the conditions required by section 167(c) and this section are otherwise met. For example, these methods of depreciation may not be used by a corporation with respect to property which it acquires from an individual or partnership in exchange for its stock. Similarly, if an individual or partnership receives property in a distribution upon dissolution of a corporation, these methods of depreciation may not be used with respect to property so acquired by such individual or partnership. As a further example, these methods of depreciation may not be used by a partnership with respect to contributed property, nor by a partner with respect to partnership property distributed to him. Moreover, where a partnership is entitled to use these depreciation methods, and the optional adjustment to basis of partnership property provided by section 743 is applicable, (i) in the case of an increase in the adjusted basis of the partnership property under such section, the transferee partner with respect to whom such adjustment is applicable shall not be entitled to use such methods with respect to such increase, and (ii) in the case of a decrease in the adjusted basis of the partnership property under such section, the transferee partner with respect to whom such adjustment is applicable shall include in his income an amount equal to the portion of the depreciation deducted by the partnership which is attributable to such decrease.

(b) *Illustrations.* (1) The application of these methods to property constructed, reconstructed, or erected by the taxpayer after December 31, 1953, may be illustrated by the following examples:

Example (1). If a building with a total cost of $100,000 is completed after December 31, 1953, and the portion attributable to construction after December 31, 1953, is determined by engineering estimates or by cost accounting records to be $30,000, the methods referred to in paragraph (a)(1) of this

section are applicable only to the $30,000 portion of the total.

Example (2). In 1954, a taxpayer has an old machine with an unrecovered cost of $1,000. If he contracts to have it reconditioned, or reconditions it himself, at a cost of an additional $5,000, only the $5,000 may be depreciated under the methods referred to in paragraph (a)(1) of this section, whether or not the materials used for reconditioning are new in use.

Example (3). A taxpayer who acquired a building in 1940 makes major maintenance or repair expenditures in 1954 of a type which must be capitalized. For these expenditures the taxpayer may use a method of depreciation different from that used on the building (for example, the methods referred to in paragraph (a)(1) of this section) only if he accounts for such expenditures separately from the account which contained the original building. In such case, the unadjusted basis on any parts replaced shall be removed from the asset account and shall be charged to the appropriate depreciation reserve account. In the alternative he may capitalize such expenditures by charging them to the depreciation reserve account for the building.

(2) The application of these methods to property which was not constructed, reconstructed, or erected by the taxpayer but which was acquired after December 31, 1953, may be illustrated by the following examples:

Example (1). A taxpayer contracted in 1953 to purchase a new machine which he acquired in 1954 and put into first use in that year. He may use the methods referred to in paragraph (a)(1) of this section, in recovering the cost of the new machine.

Example (2). A taxpayer instead of reconditioning his old machine buys a "factory reconditioned" machine in 1954 to replace it. He cannot apply the methods referred to in paragraph (a)(1) of this section, to any part of the cost of the reconditioned machine since he is not the first user of the machine.

Example (3). In 1954, a taxpayer buys a house for $20,000 which had been used as a personal residence and thus had not been subject to depreciation allowances. He makes a capital addition of $5,000 and rents the property to another. The taxpayer may use the methods referred to in paragraph (a)(1) of this section, only with respect to the $5,000 cost of the addition.

(c) *Election to use methods.* Subject to the limitations set forth in paragraph (a) of this section, the methods of computing the allowance for depreciation specified in section 167(b) (2), (3), and (4) may be adopted without permission and no formal election is required. In order for a taxpayer to elect to use these methods for any property described in paragraph (a) of this section, he need only compute depreciation thereon under any of these methods for any taxable year ending after December 31, 1953, in which the property may first be depreciated by him. The election with respect to any property shall not be binding with respect to acquisitions of similar property in the same year or subsequent year which are set up in separate accounts. If a taxpayer has filed his return for a taxable year ending after December 31, 1953, for which the return is required to be filed on or before September 15, 1956, an election to compute the depreciation allowance under any of the methods specified in section 167 (b) or a change in such an election may be made in an amended return or claim for refund filed on or before September 15, 1956.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7244, 37 FR 28897, Dec. 30, 1972]

§ 1.167(d)-1 Agreement as to useful life and rates of depreciation.

After August 16, 1954, a taxpayer may, for taxable years ending after December 31, 1953, enter into an agreement with respect to the estimated useful life, method and rate of depreciation and treatment of salvage of any property which is subject to the allowance for depreciation. An application for such agreement may be made to the district director for the internal revenue district in which the taxpayer's return is required to be filed. Such application shall be filed in quadruplicate and shall contain in such detail as may be practical the following information:

(a) The character and location of the property.

(b) The original cost or other basis and date of acquisition.

(c) Proper adjustments to the basis including depreciation accumulated to the first taxable year to be covered by the agreement.

(d) Estimated useful life and estimated salvage value.

(e) Method and rate of depreciation.

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(f) Any other facts and circumstances pertinent to making a reasonable estimate of the useful life of the property and its salvage value.

The agreement must be in writing and must be signed by the taxpayer and by the district director. The agreement must be signed in quadruplicate, and two of the signed copies will be returned to the taxpayer. The agreement shall set forth its effective date, the estimated remaining useful life, the estimated salvage value, and rate and method of depreciation of the property and the facts and circumstances taken into consideration in adoption of the agreement, and shall relate only to depreciation allowances for such property on and after the effective date of the agreement. Such an agreement shall be binding on both parties until such time as facts and circumstances which were not taken into account in making the agreement are shown to exist. The party wishing to modify or change the agreement shall have the responsibility of establishing the existence of such facts and circumstances. Any change in the useful life or rate specified in such agreement shall be effective only prospectively, that is, it shall be effective beginning with the taxable year in which notice of the intention to change, including facts and circumstances warranting the adjustment of useful life and rate, is sent by the party proposing the change to the other party and is sent by registered mail, if such notice is mailed before September 3, 1958, or is sent by certified mail or registered mail, if such notice is mailed after September 2, 1958. A copy of the agreement (and any modification thereof) shall be filed with the taxpayer's return for the first taxable year which is affected by the agreement (or any modification thereof). A signed copy should be retained with the permanent records of the taxpayer. For rules relating to changes in method of depreciation, see § 1.167 (e)-1 and section 446 and the regulations thereunder.

§ 1.167(e)-1 Change in method.

(a) *In general.* Any change in the method of computing the depreciation allowances with respect to a particular account (other than a change in method permitted or required by reason of the operation of section 167(j)(2) and § 1.167(j)-3(c)) is a change in method of accounting, and such a change will be permitted only with the consent of the Commissioner, except that certain changes to the straight line method of depreciation will be permitted without consent as provided in section 167(e) (1), (2), and (3). Except as provided in paragraphs (c) and (d) of this section, a change in method of computing depreciation will be permitted only with respect to all the assets contained in a particular account as defined in § 1.167 (a)-7. Any change in the percentage of the current straight line rate under the declining balance method, as for example, from 200 percent of the straight line rate to any other percent of the straight line rate, or any change in the interest factor used in connection with a compound interest or sinking fund method, will constitute a change in method of depreciation. Any request for a change in method of depreciation shall be made in accordance with section 446 and the regulations thereunder and shall state the character and location of the property, method of depreciation being used and the method proposed, the date of acquisition, the cost or other basis and adjustments thereto, amount recovered through depreciation and other allowances, the estimated salvage value, the estimated remaining life of the property, and such other information as may be required. For rules covering the use of depreciation methods by acquiring corporations in the case of certain corporate acquisitions, see section 381(c)(6) and the regulations thereunder.

(b) *Declining balance to straight line.* In the case of an account to which the method described in section 167(b)(2) is applicable, a taxpayer may change without the consent of the Commissioner from the declining balance method of depreciation to the straight line method at any time during the useful life of the property under the following conditions. Such a change may not be made if a provision prohibiting such a change is contained in an agreement under section 167(d). When the change is made, the unreco-

vered cost or other basis (less a reasonable estimate for salvage) shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at the time. With respect to any account, this change will be permitted only if applied to all the assets in the account as defined in § 1.167(a)-7. If the method of depreciation described in section 167(b)(2) (the declining balance method of depreciation using a rate not exceeding 200 percent of the straight line rate) is an acceptable method of depreciation with respect to a particular account, the taxpayer may elect under this paragraph to change to the straight line method of depreciation even if with respect to that particular account the declining balance method is permitted under a provision other than section 167(b)(2). Thus, for example, in the case of section 1250 property to which section 167(j)(1) is applicable, section 167(b) does not apply, but the declining balance method of depreciation using 150 percent of the straight line rate is an acceptable method of depreciation under section 167(j)(1)(B). Accordingly, the taxpayer may elect under this paragraph to change to the straight line method of depreciation with respect to such property. Similarly, if the taxpayer acquired used property before July 25, 1969, and adopted the 150 percent declining balance method of depreciation permitted with respect to such property under § 1.167(b)-0(b), the taxpayer may elect under this paragraph to change to the straight line method of depreciation with respect to such property. The taxpayer shall furnish a statement with respect to the property which is the subject of the change showing the date of acquisition, cost or other basis, amounts recovered through depreciation and other allowances, the estimated salvage value, the character of the property, the remaining useful life of the property, and such other information as may be required. The statement shall be attached to the taxpayer's return for the taxable year in which the change is made. A change to the straight line method must be adhered to for the entire taxable year of the change and for all subsequent taxable years unless, with the consent of the Commissioner, a change to another method is permitted.

(c) *Change with respect to section 1245 property.* (1) In respect of his first taxable year beginning after December 31, 1962, a taxpayer may elect, without the consent of the Commissioner, to change the method of depreciation of section 1245 property (as defined in section 1245(a)(3)) from any declining balance method or sum of the years-digits method to the straight line method. With respect to any account (as defined in § 1.167(a)-7), this change may be made notwithstanding any provision to the contrary in an agreement under section 167(d), but such change shall constitute (as of the first day of such taxable year) a termination of such agreement as to all property in such account. With respect to any account, this change will be permitted only if applied to all the section 1245 property in the account. The election shall be made by a statement on, or attached to, the return for such taxable year filed on or before the last day prescribed by law, including any extensions thereof, for filing such return.

(2) When an election under this paragraph is made in respect of section 1245 property in an account, the unrecovered cost or other basis (less a reasonable estimate for salvage) of all the section 1245 property in the account shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time. If there is other property in such account, the other property shall be placed in a separate account and depreciated by using the same method as was used before the change permitted by this paragraph, but the estimated useful life of such property shall be redetermined in accordance with § 1.167(b)-2, or 1.167(b)-3, whichever is applicable. The taxpayer shall maintain records which permit specific identification of the section 1245 property in the account with respect to which the election is made, and any other property in such account. The records shall also show for all the property in the account the

date of acquisition, cost or other basis, amounts recovered through depreciation and other allowances, the estimated salvage value, the character of the property, and the remaining useful life of the property. A change to the straight line method under this paragraph must be adhered to for the entire taxable year of the change and for all subsequent taxable years unless, with the consent of the Commissioner, a change to another method is permitted.

(d) *Change with respect to section 1250 property.* (1) In respect of his first taxable year beginning after July 24, 1969, a taxpayer may elect, without the consent of the Commissioner, to change the method of depreciation of section 1250 property (as defined in section 1250(c)) from any declining balance method or sum of the years-digits method to the straight line method. With respect to any account (as defined in § 1.167(a)-7) this change may be made notwithstanding any provision to the contrary in an agreement under section 167(d), but such change will constitute (as of the first day of such taxable year) a termination of such agreement as to all property in such account. With respect to any account, this change will be permitted only if applied to all the section 1250 property in the account. The election shall be made by a statement on, or attached to, the return for such taxable year filed on or before the last day prescribed by law, including extensions thereof, for filing such return.

(2) When an election under this paragraph is made in respect of section 1250 property in an account, the unrecovered cost or other basis (less a reasonable estimate for salvage) of all the section 1250 property in the account shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time. If there is other property in such account, the other property shall be placed in a separate account and depreciated by using the same method as was used before the change permitted by this paragraph, but the estimated useful life of such property shall be redetermined in accordance with § 1.167(b)-2 or § 1.167(b)-3, whichever is applicable. The taxpayer shall maintain records which permit specific identification of the section 1250 property in the account with respect to which the election is made and any other property in such account. The records shall also show for all the property in the account the date of the acquisition, cost or other basis, amounts recovered through depreciation and other allowances, the estimated salvage value, the character of the property, and the estimated remaining useful life of the property. A change to the straight line method under this paragraph must be adhered to for the entire taxable year of the change and for all subsequent taxable years unless, with the consent of the Commissioner, a change to another method is permitted.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6832, 30 FR 8573, July 7, 1965; T.D. 7166, 37 FR 5245, Mar. 11, 1972]

§ 1.167(f)-1 Reduction of salvage value taken into account for certain personal property.

(a) *In general.* For taxable years beginning after December 31, 1961, and ending after October 16, 1962, a taxpayer may reduce the amount taken into account as salvage value in computing the allowance for depreciation under section 167(a) with respect to "personal property" as defined in section 167(f)(2) and paragraph (b) of this section. The reduction may be made in an amount which does not exceed 10 percent of the basis of the property for determining depreciation, as of the time as of which salvage value is required to be determined (or when salvage value is redetermined), taking into account all adjustments under section 1016 other than (1) the adjustment under section 1016(a)(2) for depreciation allowed or allowable to the taxpayer, and (2) the adjustment under section 1016(a)(19) for a credit earned by the taxpayer under section 38, to the extent such adjustment is reflected in the basis for depreciation. See paragraph (c) of § 1.167(a)-1 for the definition of salvage value, the time for making the determination, the redetermination of

salvage value, and the general rules with respect to the treatment of salvage value. See also section 167(g) and § 1.167(g)-1 for basis for depreciation. A reduction of the amount taken into account as salvage value with respect to any property shall not be binding with respect to other property. In no event shall an asset (or an account) be depreciated below a reasonable salvage value after taking into account the reduction in salvage value permitted by section 167 (f) and this section.

(b) *Definitions and special rules.* The following definitions and special rules apply for purposes of section 167(f) and this section.

(1) *Personal property.* The term "personal property" shall include only depreciable—

(i) Tangible personal property (as defined in section 48 and the regulations thereunder) and

(ii) Intangible personal property

which has an estimated useful life (determined at the time of acquisition) of 3 years or more and which is acquired after October 16, 1962. Such term shall not include livestock. The term "livestock" includes horses, cattle, hogs, sheep, goats, and mink and other furbearing animals, irrespective of the use to which they are put or the purpose for which they are held. The original use of the property need not commence with the taxpayer so long as he acquired it after October 16, 1962; thus, the property may be new or used. For purposes of determining the estimated useful life, the provisions of paragraph (b) of § 1.167(a)-1 shall be applied. For rules determining when property is acquired, see subparagraph (2) of this paragraph. For purposes of determining the types of intangible personal property which are subject to the allowance for depreciation, see § 1.167(a)-3.

(2) *Acquired.* In determining whether property is acquired after October 16, 1962, property shall be deemed to be acquired when reduced to physical possession, or control. Property which has not been used in the taxpayer's trade or business or held for the production of income and which is thereafter converted by the taxpayer to such use shall be deemed to be acquired on the date of such conversion. In addition, property shall be deemed to be acquired if constructed, reconstructed, or erected by the taxpayer. If construction, reconstruction, or erection by the taxpayer began before October 17, 1962, and was completed after October 16, 1962, section 167(f) and this section apply only to that portion of the basis of the property which is properly attributable to such construction, reconstruction, or erection after October 16, 1962. Property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications. The portion of the basis of such property attributable to construction, reconstruction, or erection after October 16, 1962, consists of all costs of the property allocable to the period after October 16, 1962, including the cost or other basis of materials entering into such work. It is not necessary that such materials be acquired after October 16, 1962, or that they be new in use. If construction or erection by the taxpayer began after October 16, 1962, the entire cost or other basis of such construction or erection qualifies for the reduction provided for by section 167(f) and this section. In the case of reconstruction of property, section 167(f) and this section do not apply to any part of the adjusted basis of such property on October 16, 1962. For purposes of this section, construction, reconstruction, or erection by the taxpayer begins when physical work is started on such construction, reconstruction, or erection.

(c) *Illustrations.* The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). Taxpayer A purchases a new asset for use in his business on January 1, 1963, for $10,000. The asset qualifies for the investment credit under section 38 and for the additional first-year depreciation allowance under section 179. A is entitled to an investment credit of $700 (7%×$10,000) and elects to take an additional first-year depreciation allowance of $2,000 (20%×$10,000). The basis for depreciation (determined in accordance with the provisions of section 167(g) and § 1.167(g)-1) is computed as follows:

Purchase price		$10,000
Less: Adjustment required for taxable years beginning before Jan. 1, 1964, under section 1016(a)(19), for the investment credit	$700	
Adjustment required under section 1016(a)(2) for the additional first-year depreciation allowance	2,000	
		2,700
Basis for depreciation for the taxable year 1963		7,300

However, the basis of the property for determining depreciation as of the time as of which salvage value is required to be determined is $10,000, the purchase price of the property. A files his income tax returns on a calendar year basis and uses the straight line method of depreciation. A estimates that he will use the asset in his business for 10 years after which it will have a salvage value of $500, which is less than $1,000 (10%×$10,000, the basis of the property for determining depreciation as of the time as of which salvage value is required to be determined). For the taxable year 1963 A may deduct $730 as the depreciation allowance. As of January 1, 1964, the basis of the asset is increased by $700 in accordance with paragraph (d) of § 1.48-7. In computing his total depreciation allowance on the asset, A may reduce the amount taken into account as salvage value to zero and may claim depreciation deductions (including the additional first-year depreciation allowance) totaling $10,000. See paragraph (d) of § 1.48-7 for the computation of depreciation for taxable years beginning after December 31, 1963, where there is an increase in basis of property subject to the investment credit.

Example (2). Assume the same facts as in example (1) except that A in a subsequent taxable year redetermines the estimate of the useful life of the asset and at the same time also redetermines the estimate of salvage value. Assume also that at such time the only reductions reflected in the basis are for depreciation allowed or allowable. Accordingly, the reduction under section 167(f) and this section will be computed with regard to the purchase price and not the unrecovered basis for depreciation at the time of the redetermination.

Example (3). Assume the same facts as in example (1) except that A estimates that the asset will have a salvage value of $1,200 at the end of its useful life. In computing his depreciation for the asset, A may reduce the amount to be taken into account as salvage value to $200 ($1,200−$1,000). Accordingly, A may claim depreciation deductions (including the additional first-year depreciation allowance) totaling $9,800, i.e., the purchase price of the property ($10,000) less the amount taken into account as salvage value ($200).

Example (4). Assume the same facts as in example (1) except that the taxpayer had taken into account salvage value of only $200 but that the estimated salvage value had actually been $700. The amount of salvage value taken into account by the taxpayer is permissible since the reduction of salvage value by $500 ($700−$200) would be within the limit provided for in section 167 (f), i.e., $1,000 (10%×$10,000).

Example (5). On January 1, 1963, taxpayer B, a taxicab operator, traded his old taxicab plus cash for a new one, which had an estimated useful life of three years, in a transaction qualifying as a nontaxable exchange. The old taxicab had an adjusted basis of $2,500. B was allowed $3,000 for his old taxicab and paid $1,000 in cash. The basis of the new taxicab for determining depreciation (as determined under section 167(g) and § 1.167(g)-1) is the adjusted basis of the old taxicab at the time of trade-in ($2,500) plus the additional cash paid out ($1,000), or $3,500. In computing his depreciation allowance on the new taxicab, B may reduce the amount taken into account as salvage value by $350 (10% of $3,500).

Example (6). Taxpayer C purchases a new asset for use in his business on January 1, 1963, for $10,000. At the time of purchase, the asset has an estimated useful life of 10 years and an estimated salvage value of $1,500. C elects to compute his depreciation allowance for the asset by the declining balance method of depreciation, using a rate of 20% which is twice the normal straight line rate of 10% (without adjustment for salvage value). C files his income tax returns on a calendar year basis. In computing his depreciation allowance for the year 1966, C changes his method of determining the depreciation allowance for the asset from the declining balance method to the straight line method (in which salvage value is accounted for in determining the annual depreciation allowances) in accordance with the provisions of section 167(e) and paragraph (b) of § 1.167(e)-1. He also wishes to reduce the amount of salvage value taken into account in accordance with the provisions of section 167(f) and this section. At the close of the year 1966, the only reductions reflected in the basis of the asset are for depreciation allowances. Thus, C may reduce the amount of salvage value taken into account by $1,000 (10%×$10,000, the basis of the asset when it was acquired), and, therefore, will account for salvage value of only $500 in computing his depreciation allowance for the asset in 1966 and subsequent years.

Example (7). Taxpayer D purchases a station wagon for his personal use on January 1, 1962, for $4,500. On January 1, 1963, D converts the use of the station wagon to his business, and at that time it has an estimat-

ed useful life of 4 years, an estimated salvage value of $500, and a basis of $3,000 (as determined under section 167 (g) and § 1.167 (g)–1). Thus, for purposes of section 167 (f) and this section, D is deemed to have acquired the station wagon on January 1, 1963. D elects the straight line method of depreciation in computing the depreciation allowance for the station wagon and also wishes to reduce the amount of salvage value taken into account in accordance with the provisions of section 167(f) and this section. Accordingly, D may reduce the amount of salvage value taken into account by $300 (10% of $3,000). D files his income tax returns on a calendar year basis. His depreciation allowance for the year 1963 would be computed as follows:

Basis for depreciation		$3,000
Less:		
Salvage value	$500	
Reduction permitted by section 167(f)	300	
		200
Amount to be depreciated over the useful life		2,800

D's depreciation allowance on the station wagon for the year 1963 would be $700 ($2,800 divided by 4, the remaining useful life).

[T.D. 6712, 29 FR 3654, Mar. 24, 1964, as amended by T.D. 6838, 30 FR 9064, July 20, 1965]

§ 1.167(g)–1 Basis for depreciation.

The basis upon which the allowance for depreciation is to be computed with respect to any property shall be the adjusted basis provided in section 1011 for the purpose of determining gain on the sale or other disposition of such property. In the case of property which has not been used in the trade or business or held for the production of income and which is thereafter converted to such use, the fair market value on the date of such conversion, if less than the adjusted basis of the property at that time, is the basis for computing depreciation.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960. Redesignated, T.D. 6712, 29 FR 3653, Mar. 24, 1964]

§ 1.167(h)–1 Life tenants and beneficiaries of trusts and estates.

(a) *Life tenants.* In the case of property held by one person for life with remainder to another person, the deduction for depreciation shall be computed as if the life tenant were the absolute owner of the property so that he will be entitled to the deduction during his life, and thereafter the deduction, if any, shall be allowed to the remainderman.

(b) *Trusts.* If property is held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depreciation in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depreciation reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each. For example:

(1) If under the trust instrument or local law the income of a trust computed without regard to depreciation is to be distributed to a named beneficiary, the beneficiary is entitled to the deduction to the exclusion of the trustee.

(2) If under the trust instrument or local law the income of a trust is to be distributed to a named beneficiary, but the trustee is directed to maintain a reserve for depreciation in any amount, the deduction is allowed to the trustee (except to the extent that income set aside for the reserve is less than the allowable deduction). The same result would follow if the trustee sets aside income for a depreciation reserve pursuant to discretionary authority to do so in the governing instrument.

No effect shall be given to any allocation of the depreciation deduction which gives any beneficiary or the trustee a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument except as otherwise provided in this paragraph when the trust instrument or local law

requires or permits the trustee to maintain a reserve for depreciation.

(c) *Estates.* In the case of an estate the allowable deduction shall be apportioned between the estate and the heirs legatees, and devisees on the basis of income of the estate which is allocable to each.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960. Redesignated, T.D. 6712, 29 FR 3653, Mar. 24, 1964]

§ 1.167(i)-1 Depreciation of improvements in the case of mines, etc.

Property used in the trade or business or held for the production of income which is subject to the allowance for depreciation provided in section 611 shall be treated for all purposes of the Code as if it were property subject to the allowance for depreciation under section 167. The preceding sentence shall not limit the allowance for depreciation otherwise allowable under section 611.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960. Redesignated, T.D. 6712, 29 FR 3653, Mar. 24, 1964]

§ 1.167(j)-1 Special rules for section 1250 property.

(a) *Depreciation of section 1250 property*—(1) *General.* In the case of section 1250 property, section 167(j) provides limitations on the methods of depreciation which will be considered to result in a reasonable allowance under section 167(a). Generally, in the case of section 1250 property the original use of which commences with the taxpayer after July 24, 1969, the 200 percent declining balance and sum of the years-digits methods of depreciation are available only with respect to residential rental property (sec. 167(j)(2)); other such property is limited to the straight line method, the 150 percent declining balance method, or any other consistent method described in subparagraph (C) of section 167(j)(1) (sec. 167(j)(1)). Under section 167(j)(3), if construction of section 1250 property has begun before July 25, 1969, or if there is a written contract binding on the taxpayer for construction or permanent financing on that date, the property is not subject to the limitations of section 167(j)(1). In the case of section 1250 property acquired after July 24, 1969, the original use of which does not commence with the taxpayer, section 167(j)(4) provides that the straight line method of depreciation generally is the only method which will be considered to result in a reasonable allowance under section 167(a); except that, under section 167(j)(5), if such property has a useful life of 20 years or more and qualifies as residential rental property, the 125 percent declining balance method may be used. Section 167 (j)(6)(C) provides that if used section 1250 property is acquired after July 24, 1969, pursuant to a written contract for acquisition or for permanent financing which was, on July 24, 1969, and at all times thereafter, binding on the taxpayer, such property is not subject to the limitations of section 167(j) (4) and (5). Section 167(j)(6)(A) provides that rules similar to the rules contained in paragraphs (5), (9), (10), and (13), of section 48(h) shall be applied for purposes of paragraphs (3), (4), and (5) of section 167(j).

(2) *Meaning of terms.* For purposes of this section and §§ 1.167(j)-2 through 1.167(j)-7—

(i) The term "section 1250 property" means any real property (other than sec. 1245 property, as defined in sec. 1245(a)(3)) which is or has been property of a character subject to the allowance for depreciation provided in section 167; and

(ii) The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of the property by the taxpayer. (See § 1.167(c)-1(a).)

[T.D. 7166, 37 FR 5238, Mar. 11, 1972]

§ 1.167(j)-2 Depreciation of new section 1250 property.

(a) *Depreciation of new section 1250 property*—(1) *General rule.* Except as provided in §§ 1.167(j)-3 and 1.167(j)-4, section 167(b) shall not apply in the case of section 1250 property the original use of which commences with the taxpayer after July 24, 1969, and the methods of depreciation described in paragraph (b) of this section shall be deemed to produce a reasonable allowance for depreciation. Any other reasonable and consistently applied

method of computing depreciation may be used unless such method is allowable solely by reason of paragraph (2), (3), or (4) of section 167(b). The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. Generally, depreciation deductions so claimed will be changed only where there is a clear and convincing basis for the change. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property.

(2) *Application of methods.* For principles governing the application of methods to item, group, classified, or composite accounts, see § 1.167(b)-0(c).

(b) *Depreciation methods*—(1) *Straight line method.* For principles governing the computation of depreciation under the straight line method, see § 1.167(b)-1.

(2) *Declining balance method.* (i) Under the declining balance method a uniform rate is applied each year to the unrecovered cost or other basis of the property. The unrecovered cost or other basis is the basis provided by section 167(g), adjusted for depreciation previously allowed or allowable, and for all other adjustments provided by section 1016 and other applicable provisions of law. The declining balance rate may be determined without resort to formula. Such rate determined under section 167(j)(1)(B) shall not exceed 150 percent of the appropriate straight line rate computed without adjustment for salvage. While salvage is not taken into account in determining the annual allowances under this method, in no event shall an asset (or an account) be depreciated below a reasonable salvage value.

(ii) In the declining balance method when a change is justified in the useful life estimated for an account, subsequent computations shall be made as though the revised life had been originally estimated. For example, assume that an account has an estimated useful life of 10 years and that the declining balance method using a 15 percent rate (150 percent of the straight line rate computed without adjustment for salvage (10 percent)) is adopted. If, at the end of the fourth year, it is determined that the remaining useful life of the account is 8 years, computations shall be made as though the estimated useful life was originally determined as 12 years. Accordingly, the applicable depreciation rate will be 12½ percent (150 percent × 1/12). This rate is thereafter applied to the uncovered cost or other basis.

(3) *Other methods.* (i) Under section 167(j)(1)(C), a taxpayer may use any consistent method of computing depreciation, such as the sinking fund method, provided depreciation allowances computed in accordance with such method do not result in accumulated allowances at the end of any taxable year greater than the total of the accumulated allowances which would have resulted from the use of the declining balance method described in section 167(j)(1)(B). This limitation applies only during the first two-thirds of the useful life of the property. For example, an asset costing $320, having a useful life of 6 years, may be depreciated under the declining balance method in accordance with subparagraph (2) of this paragraph at a rate of 25 percent. During the first 4 years (two-thirds of the useful life), maximum depreciation allowances under this method would be as follows:

	Current depreciation	Accumulated depreciation	Balance
Cost of asset			$320.00
First year	$80.00	$80.00	240.00
Second year	60.00	140.00	180.00
Third year	45.00	185.00	135.00
Fourth year	33.75	218.75	101.25

An annual allowance computed by any other method under section 167(j)(1)(C) could not exceed $80 for the first year, and at the end of the second year the total allowances for the 2 years could not exceed $140. Likewise, the total allowances for the

first 3 years could not exceed $185 and for the first 4 years could not exceed $218.75. This limitation would not apply in the fifth and sixth years.

(ii) It shall be the responsibility of the taxpayer to establish to the satisfaction of the Commissioner that a method of depreciation under section 167(j)(1)(C) is both a reasonable and consistent method and that it does not produce depreciation allowances in excess of the amount permitted under the limitations provided in such section.

[T.D. 7166, 37 FR 5239, Mar. 11, 1972; 37 FR 6400, Mar. 29, 1972]

§ 1.167(j)-3 Residential rental property.

(a) *In general.* Section 167(j)(1) shall not apply and section 167(b) shall apply (subject to the limitations of section 167(c)) in the case of residential rental property (as defined in section 167(j)(2)(B)) the original use of which commences with the taxpayer: *Provided,* That—

(1) Such property is located in the United States or any of its possessions, or

(2) Such property is located within a foreign country, and the laws of such country provide a method of depreciation for such property comparable to the declining balance or sum of the years-digits method of depreciation. If this subparagraph applies to property located within a foreign country, and if the allowance for depreciation provided under the laws of such country is greater than that provided under section 167(j)(1), but less than the maximum depreciation allowance computed under section 167(b), then the amount of depreciation computed under section 167(b) shall not exceed the amount of depreciation computed under the laws of such foreign country.

For purposes of this paragraph, a method of depreciation shall be considered comparable to the declining balance or sum of the years-digits method only if such method results in depreciation allowances during the first two-thirds of the useful life of the property (determined under § 1.167(a)-1(b)) which are greater than depreciation allowances computed under the declining balance method of depreciation using 150 percent of the straight line rate computed without adjustment for salvage.

(b) *Definition of residential rental property*—(1) *In general.* (i) The term "residential rental property" means, for any taxable year, a building or structure used to provide living accommodations on a rental basis: *Provided,* That 80 percent or more of the gross rental income (as defined in subparagraph (2) of this paragraph) for such taxable year from such building or structure is rental income from dwelling units. Generally, a dwelling unit is a house or an apartment used to provide living accommodations but does not include any unit in a hotel, motel, inn, or other establishment more than one-half of the units in which are used on a transient basis (see § 1.167(k)-3(c)).

(ii) In any case where two or more buildings or structures on a single tract or parcel (or contiguous tracts or parcels) of land are operated as an integrated unit (as evidenced by their actual operation, management, financing, and accounting), they may be treated as a single building for purposes of this paragraph. For example, if the gross rental income from two such buildings were $1 million and $5 million respectively, and if the gross rental income from dwelling units in such buildings were $900,000 and $3,900,000 respectively, the buildings could be considered residential rental property because 80 percent ($4,800,000/$6,000,000) of the gross rental income from the two buildings is from dwelling units.

(2) *Gross rental income defined.* (i) For purposes of this paragraph, the term "gross rental income" means, generally, the gross amounts received from the use of or the right to use real property. If an amount is received with respect to property consisting of both real and personal property, such as a furnished house or apartment, that portion of the rent attributable to the personal property does not constitute gross rental income.

(ii) If an amount is received with respect to a facility located outside a building, such amount may constitute gross rental income from the building

or buildings which the facility serves, provided—

(*a*) The facility is of the kind that customarily is associated with the occupancy of a living accommodation, such as a parking lot, swimming pool, or recreation area;

(*b*) The facility is principally for the benefit of tenants of the building (or buildings); and

(*c*) If separate charges are made to the tenants for the use of the facility, at least 80 percent of the gross income from the facility is from such tenants. If less than 80 percent of the gross income from a facility outside the building is from tenants of the building (or buildings), none of the income from the facility is gross rental income from the building (or buildings).

A grocery store, drugstore, commercial laundry, or other commercial operation is not associated with the occupancy of a living accommodation.

(iii) The gross amount attributable to the furnishing of services which are usually or customarily attributable to the use of or right to use real property constitutes gross rental income from the building. However, the gross amount attributable to the performance of significant services for the occupant which are other than those usually or customarily rendered in connection with the mere rental of rooms or other space for occupancy does not constitute gross rental income from the building. Amounts attributable to the performance of maid service, for example, do not constitute gross rental income, whereas amounts attributable to the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, etc., would generally constitute gross rental income. Where an amount is paid by the tenant directly to an independent contractor, such as an amount paid to a public utility for electricity or gas, such amount does not constitute gross rental income from the building.

(3) *Gross rental income from a dwelling unit.* Gross rental income from a building is gross rental income from a dwelling unit in such building only if it is attributable to or ordinarily associated with the use of, or the right to use, such unit as a living accommodation. The right to use a parking space or a swimming pool is ordinarily associated with the right to use a dwelling unit as a living accommodation. Accordingly, an amount paid by the tenant of a dwelling unit for such a parking space or swimming pool is gross rental income from a dwelling unit. If a portion of the building is used for a drugstore, grocery store, commercial laundry, or other commercial operation, the rent paid for such portion (including any amount paid for services in connection with such a commercial operation) is not rental income from a dwelling unit. Similarly, if pursuant to the terms of a lease or other agreement, a portion of a house or apartment is used as office space, such as a doctor's office, the rent paid with respect to such portion is gross rental income from the building but is not rental income from a dwelling unit.

(4) *Special rules.* (i) For purposes of computing the gross rental income from a building or structure, the rental at which a vacant unit is offered is not taken into account.

(ii) Rent supplement payments under section 221(d)(3) of the National Housing Act and interest reduction payments under section 236 of the National Housing Act made on behalf of tenants occupying dwelling units, will be taken into account as gross rental income from dwelling units.

(iii) If any portion of a building or structure is occupied by the taxpayer, the fair rental value of such portion shall be included in gross rental income in determining whether the building or structure qualifies as residential rental property. Thus, if the taxpayer uses space in the building for the operation of a drug store the fair rental value of the space is treated as gross rental income from the building but not as rent from a dwelling unit.

(iv) If the taxpayer reserves space in a building for a rental office, for the storage of tools and equipment, for occupancy by a resident manager or maintenance personnel, or for other similar purposes, such space is not treated as occupied by the taxpayer.

(v) For purposes of determining whether property qualifies as residential rental property for a taxable year

under section 167(j)(2)(B), only the gross rental income attributable to that portion of the year in which the taxpayer is entitled to compute depreciation with respect to the property shall be taken into account. (For period when depreciation is allowable, see § 1.167(a)-10.) Thus, if a calendar year taxpayer acquires a building on June 15, 1970, which had been placed in service on January 1, 1970, only the rent attributable to the period from June 15, 1970, to December 31, 1970, shall be taken into account for 1970 for purposes of section 167(j)(2)(B).

(5) *Certain records required.* The taxpayer shall maintain a record of the gross rental income derived from a building, and the portion thereof which constitutes gross rental income from dwelling units, in addition to the records required under § 1.167(a)-7(c) with respect to property in a depreciation account.

(6) *Examples.* The principles of this paragraph may be illustrated by the following examples:

Example (1). A constructs a six-story building, beginning after July 24, 1969. The building is placed in service in 1970. The first floor is rented to a commercial store and the remaining area, consisting of 25 dwelling units, is rented to tenants for living accommodations. The gross rental income from the store during 1970 is $15,000 and the gross rental income from the dwelling units is $60,000. Since 80 percent ($60,000/$75,000) of the gross rental income constitutes rental income from dwelling units, the building qualifies as residential rental property for 1970.

Example (2). The facts are the same as in example (1), except that A operates the commercial store himself and lives in one of the dwelling units. Assuming that the fair rental value for the commercial store and for the dwelling units are the amounts set forth in example (1), the building qualifies as residential rental property for 1970, since the fair rental value of the commercial store and of the dwelling unit are treated as rental income from the building.

Example (3). The facts are the same as in example (1). In 1971, the gross rental income from the store is $18,000 and the gross rental income from the dwelling units is $64,000. Since only 78.05 percent ($64,000/$82,000) of the gross rental income is rental income from dwelling units, the building does not qualify as residential rental property for 1971.

(c) *Change in depreciation method—*(1) *In general.* Any change in the computation of the allowance for depreciation with respect to any section 1250 property for any taxable year, permitted or required by reason of the qualification or disqualification of such property as residential rental property under paragraph (b) of this section, shall not be considered a change in a method of accounting. For purposes of this paragraph, a change in the computation of the allowance for depreciation is permitted in any taxable year without consent only if property qualifies as residential rental property for such year and did not qualify as residential rental property in the first taxable year in which the current method of depreciation with respect to such property was adopted. Further, for purposes of this paragraph, a change in the computation of the allowance for depreciation is required in any taxable year only if the property is subject to the limitations of section 167(j)(1) (or section 167(j)(4) in the case of used section 1250 property) for such year and the current method of depreciation with respect to the property is not permitted under section 167(j)(1) (section 167(j)(4) in the case of used section 1250 property). If a change in the computation of the allowance for depreciation is not permitted or required under this paragraph, such change is considered a change in a method of accounting for which the taxpayer must secure the consent of the Secretary or his delegate. (See section 446(e).) However, see section 167(e) for special rules relating to certain changes in the method of computing depreciation which do not require such consent. See § 1.167(a)-11(c)(1) for special rule for change in depreciation method with respect to property for which an election under § 1.167(a)-11 has been made. The principles of this subparagraph may be illustrated by the following examples:

Example (1). In 1970, A constructs a building which qualifies as residential rental property and adopts the sum of the years-digits method of depreciation. In 1971, the building does not qualify as residential rental property. A is required to adopt a method of depreciation permitted under section 167(j)(1) for 1971 with respect to the

building, such as the declining balance method using 150 percent of the straight line rate computed without adjustment for salvage. The change of depreciation method for 1971 is not considered a change in a method of accounting.

Example (2). The facts are the same as in example (1). In 1972, the building again qualifies as residential rental property. A may adopt any method of depreciation described in section 167(b) for 1972, subject to the limitations of section 167(c), and this change of depreciation method is not considered a change in a method of accounting.

Example (3). The facts are the same as in example (1), except that in 1970 the taxpayer adopts the 150 percent declining balance method of depreciation. Any change in the computation of the allowance for depreciation for any subsequent year would be considered a change in a method of accounting.

(2) *Computation of depreciation after change in method.* If a change in the computation of the allowance for depreciation is permitted or required under subparagraph (1) of this paragraph, the unrecovered cost or other basis (less a reasonable estimate for salvage if required under the new method of depreciation) shall be recovered through annual allowances over the estimated remaining useful life of the property. The rate of depreciation for property changed to the straight line or sum of the years-digits method of depreciation shall be based upon the estimated remaining useful life of the property at the time of the change. The rate of depreciation for property changed to any declining balance method shall be based upon the estimated useful life of such property as of the date such property was placed in service by the taxpayer. The taxpayer shall furnish a statement with respect to the property which is the subject of the change showing the date of acquisition, cost or other basis, amounts recovered through depreciation and other allowances, the estimated salvage value, the character of the property, the estimated useful life of the property, and such other information as may be required. The statement shall be attached to the taxpayer's return for the taxable year in which the change is made. If a change in the computation of the allowance for depreciation is made, the new method of depreciation must be adhered to for the entire taxable year of the change and for all subsequent taxable years unless in a subsequent year—

(i) The taxpayer is permitted or required to change to a different method of depreciation under subparagraph (1) of this paragraph, or

(ii) A change in depreciation method is made with the consent of the Commissioner (see section 446(e) and § 1.167(a)-11(c)(1)).

(3) *Example.* The principles of this paragraph may be illustrated by the following example.

Example. (i) Beginning after July 24, 1969, B constructs a building which is placed in service on January 1, 1970. The building has a cost of $100,000, a 40-year useful life, and a $10,000 salvage value. In 1970, the building does not qualify as residential rental property and B adopts the declining balance method of depreciation using 150 percent of the straight line rate computed without adjustment for salvage. B may claim a depreciation deduction of $3,750 for 1970 (0.0375×$100,000).

(ii) In 1971, the building qualifies as residential rental property and B adopts the sum of the years-digits method of depreciation. At that time, the property has a remaining estimated useful life of 39 years, a salvage value of $10,000, and an adjusted basis of $96,250. Table I of § 1.167(b)-3(a) shows that the decimal equivalent for a 39-year useful life under the sum of the years-digits method is 0.0500. Since the adjusted basis less salvage value is $86,250, B may claim a depreciation deduction of $4,312.50 (0.05×$86,250) for 1971.

(iii) In 1972, the building does not qualify as residential rental property and B adopts the declining balance method of depreciation using 150 percent of the straight line rate computed without adjustment for salvage. The adjusted basis of the property is now $91,937.50 ($96,250 minus $4,312.50) and B may claim a depreciation deduction of $3,447.66 for 1972 (0.0375×$91,937.50).

[T.D. 7166, 37 FR 5239, Mar. 11, 1972]

§ 1.167(j)-4 Property constructed, etc., before July 25, 1969.

(a) *Construction, reconstruction, or erection*—(1) *General rule.* Section 167(j)(3)(A) provides that section 167(j)(1) shall not apply and section 167(b) shall apply (subject to the limitations contained in section 167(c)) in the case of any section 1250 property the construction, reconstruction, or erection of which (whether or not by

the taxpayer) was begun before July 25, 1969. Where construction, reconstruction, or erection was begun before July 25, 1969, the limitations of section 167(j)(1) do not apply to the completed building (including structural components necessary to the operation of the building, such as a furnace and central air conditioning unit), provided that the building is completed substantially in accordance with the building description in the contract on July 24, 1969. If there is a substantial modification in the building described in the contract after July 24, 1969 (other than a modification required by a Federal, State, or local agency), any section 1250 property which was not an integral part of the building as described in the contract on July 24, 1969, shall not qualify under this subparagraph. (See, however, § 1.167(j)–7.) A substantial modification will be considered to have occurred only if the size, estimated cost, or estimated rental value of the building subject to the contract is changed by more than 20 percent. Any property which is an integral part of the building described in the contract on July 24, 1969, may qualify under this paragraph even if such property is attributable to a modification that is not considered substantial under this subparagraph. For example, if the taxpayer begins the construction of a 25-unit motel before July 25, 1969, but changes his plans after July 24, 1969, and constructs a 40-unit motel, the section 1250 property which is a part of, or attributable to, the construction of the additional 15 units does not qualify under this subparagraph. The principles of this subparagraph may be illustrated by the following example:

Example. C begins the cosntruction of a building before July 25, 1969. Prior to completion, the building is sold to D. upon completion, D may adopt any method of depreciation described in section 167(b), since the construction began before July 25, 1969, and the original use of the property commenced with D. The result would be the same if D acquired the building after compeltion of construction, but before the building was placed in service.

(2) *Commencement of construction.* For purposes of this section, the construction, reconstruction, or erection of section 1250 property begins upon the commencement of physical work at the building site, as distinguished from the beginning of, or engaging in, certain preliminary activities, and this determination shall be based upon all of the facts and circumstances of a particular case. Thus, activities such as test drilling to determine soil conditions, the preparation of architect's sketches, and similar preliminary work does not constitute the beginning of construction, reconstruction, or erection of a building. On the other hand, the grading of land, the digging of the footings of a building, the excavation of a building site for the purpose of sinking a foundation shoring composite wall, or the driving of foundation piles would constitute the beginning of physical construction of a building. The principles of this subparagraph may be illustrated by the following example:

Example. On February 15, 1969, M Corporation acquires property. On April 10, 1969, M engages the N Construction Co. to construct a community center consisting of theaters, office buildings, and a subterranean garage, the size, estimated cost, and rental value of which are described in the contract entered into on that date. On July 24, 1969, N has completed approximately 25 percent of the excavation for the purpose of sinking a foundation-shoring composite wall. Prior to July 25, 1969, M has made two progress payments to N totaling in excess of $200,000. The excavation prior to July 25, 1969, of a portion of the dirt to be removed for the purpose of sinking the foundation-shoring composite wall, constitutes the beginning of physical construction for purposes of this section.

(b) *Binding contract for construction*—(1) *General rule.* Section 167(j)(3)(B) provides that section 167(j)(1) shall not apply and section 167(b) shall apply (subject to the limitations contained in section 167(c)) in the case of any section 1250 property for which a written contract with respect to any part of the construction, reconstruction, or erection, or for a substantial portion of the permanent financing, was on July 25, 1969, and at all times thereafter, binding on the taxpayer. A contract for construction, reconstruction, or erection shall not be considered a binding contract under

section 167(j)(3)(B) unless such contract meets the requirements of subparagraphs (2) through (7) of this paragraph. A contract with respect to permanent financing shall not be considered a binding contract for purposes of section 167(j)(3)(B), unless such contract meets the requirements of paragraph (c) of this section.

(2) *Type of contract.* (i) A contract for the construction, reconstruction, or erection of property will qualify under this paragraph only if—

(*a*) The construction, reconstruction, or erection of such property is the subject matter of the contract,

(*b*) The contract provides that the property is to be constructed, reconstructed, or erected by or for the taxpayer (or his assignor if the assignment occurred before July 25, 1969),

(*c*) The contract (or related documents) contains a description of the building sufficient to determine the size, estimated cost, and estimated rental value of the property to be constructed, reconstructed, or erected, and either

(*d*) The parties to the contract are the taxpayer (or his assignor if the assignment occurred before July 25, 1969), and the person who is to construct, reconstruct, or erect property for the taxpayer, or

(*e*) The parties to the contract are the taxpayer (or his assignor if the assignment occurred before July 25, 1969), and the person with whom or for whom the taxpayer agrees to construct, reconstruct, or erect property.

(ii) Section 167(j)(3)(B) does not apply if a person who is a party to a binding contract under this paragraph transfers rights in such contract (or in the property to which such contract relates) after July 25, 1969, to another person, even though the first person retains a right to use the property under a lease with such other person. For example, if, after July 25, 1969, A begins the construction of a building for B under a contract entered into before July 25, 1969, and B then sells his rights under the contract to C, this paragraph does not apply to the property in C's hands, even though this paragraph would have applied to the property in B's hands. See § 1.167(j)-7(a)(3) for certain cases where a transfer of property which is subject to a binding contract will be disregarded.

(3) *Legal formality.* (i) An agreement shall be considered as a contract binding on the taxpayer, for purposes of this paragraph, only if such agreement is in writing, constitutes a contract under applicable State or local law, and is enforceable against the taxpayer under such law. A contract which does not represent a bona fide agreement negotiated at arm's length shall not be considered a binding contract under this paragraph. In any case where a person that is named as a party to the contract is acting solely as a mere nominee, the real party in interest shall be considered a party to the contract.

(ii) The principles of this subparagraph may be illustrated by the following examples:

Example (1). A is the owner of a parcel of land. B owns and operates department stores. On July 1, 1969, A and B enter into a contract under which B agrees to lease the land from A and to build and operate a department store on the leased property. If the contract adequately describes the building to be constructed, the contract between A and B may qualify as a binding contract under this subparagraph.

Example (2). C and D each owns and operates department stores. On March 21, 1969, C and D enter into a contract under which each party agrees to construct a building on land owned by E. If the contract adequately describes the buildings to be constructed, the contract between C and D may qualify as a binding contract for purposes of this subparagraph.

(4) *Liability for and amount of damages.* A contract will not be considered to be binding upon the taxpayer for purposes of this paragraph unless (i) the taxpayer's failure to perform would subject him or his property to liability for damages or to a forfeiture of a down payment or a deposit, and (ii) the amount of such liability for damages is not limited by the terms of the contract or, if contractually limited the liability or forfeiture is more than nominal. If the deposit, liquidated damages, or down payment is consistent with the normal commercial practices in the locality, the contract may qualify under this paragraph. It is not required that the taxpayer be subject to personal liability for such

damages. For example, if the taxpayer's liability is limited and enforceable only against the taxpayer's property, the contract may still qualify under this subparagraph.

(5) *Continuing existence of contract and its terms.* A contract shall qualify as a binding contract for purposes of this paragraph only if such contract is (i) binding upon the taxpayer on July 25, 1969, and at all times thereafter until performance under the contract is completed, and (ii) performance is substantially in accordance with the terms of the contract as such terms existed on July 24, 1969. A contract whose terms are substantially modified after July 24, 1969 (other than by a modification required by a Federal, State, or local agency), will not be considered a binding contract for purposes of this paragraph with respect to any property which was not an integral part of the building as described in the contract on July 24, 1969. (See, however, § 1.167(j)-7.) A modification of a contract will be considered substantial only if the size, estimated cost, or estimated rental value of the building is changed by more than 20 percent. Property attributable to a modification that is not considered substantial may qualify under this paragraph. A modification of a contract in which the lessee of property becomes the purchaser, or the purchaser of property becomes the lessee, would not be considered a substantial modification in the absence of any other factors. On the other hand, if a contract which provides for the construction of a three-story office building is modified to provide for the construction of an eight-story office building, such modification would be a substantial modification, and therefore, the contract would be considered binding only with respect to the property subject to the contract before the modification.

(6) *Contract with undetermined terms or conditions.* A contract may be binding upon the taxpayer under this paragraph even if some of its terms are to be determined at a date later than July 25, 1969, provided that the determination of such terms is not within the unrestricted control of the taxpayer, and such terms are in fact subsequently determined. Similarly, a contract may be binding upon the taxpayer under this paragraph even if it is subject to the happening of certain contingencies which have not occurred by July 25, 1969, provided that the happening of such contingencies is not within the unrestricted control of the taxpayer, and the contingencies in fact occur.

(7) *Extent of taxpayer's obligations.* A contract with respect to the construction, reconstruction, or erection of property will meet the requirements of this paragraph only if performance of the contract would be considered the commencement of construction under paragraph (a)(2) of this section and the building is adequately described in the contract on July 24, 1969. Thus, for example, a contract for the preparation of architect's sketches, or for test drilling to determine soil conditions, would not be considered a binding contract for construction. On the other hand, if performance of a contract would be considered the commencement of construction under paragraph (a)(2) of this section and if the size, estimated cost, and estimated rental value of the building to be constructed are determinable from the provisions of the contract on July 24, 1969, the completed building (including structural components necessary for the operation of the building, such as a furnance and central air conditioning unit) may qualify under section 167(j)(3)(B). It is not required that detailed construction plans and specifications be in existence on July 24, 1969. Thus, for example, if a taxpayer enters into a contract for the construction of a building shell on July 1, 1969, and the size, estimated cost, and estimated rental value of the building are determinable on July 24, 1969, the completed building, including plumbing and heating not subject to such contract, may qualify under section 167(j)(3)(B). On the other hand, if the size, estimated cost, or estimated rental value of the building is not determinable on July 24, 1969, only the property which is specifically described in the contract may qualify under section 167(j)(3)(B). (See, however, § 1.167 (j)-7.)

(c) *Contract for permanent financing*—(1) *General rule.* Section 167

(j)(3)(B) provides that section 167(j)(1) shall not apply and section 167(b) shall apply (subject to the limitations of section 167(c)) in the case of any section 1250 property for which a written contract with respect to a substantial portion of the permanent financing of such property was binding on the taxpayer on July 25, 1969, and at all times thereafter. A contract for permanent financing will qualify under section 167(j)(3)(B) only if such contract meets the requirements of subparagraphs (2) through (7) of this paragraph.

(2) *Nature of permanent financing contract.* A contract will qualify under this paragraph only if (i) the contract specifically describes the property to be constructed, reconstructed, or erected as to size, estimated cost, and estimated rental value, (ii) the parties to the contract are the taxpayer and an independent lender, (iii) the contract provides permanent financing after the scheduled completion of the project and the liquidation of interim construction financing, and (iv) the contract provides funds covering a substantial portion of the permanent financing of the property to be constructed, reconstructed, or erected. Generally, a financing agreement will be considered to cover a substantial portion of the permanent financing of the property if the terms of the agreement provide for lending of an amount in excess of 40 percent of that portion of the reasonably estimated cost of construction, reconstruction, or erection of the property, which is to be financed by borrowing. A financing agreement may qualify under this paragraph if funds are provided in the form of a loan, a purchase of the property coupled with a lease-back to the taxpayer, or any similar type of transaction in the nature of a loan. For purposes of this subparagraph, an independent lender need not necessarily be a bank, building and loan association, or other financing institution, provided that the agreement represents a bona fide commitment of funds on behalf of a financially responsible person or organization, negotiated at arm's length.

(3) *Legal formality.* In order for a financing agreement to qualify as permanent financing under this paragraph, such agreement must be in writing, must constitute a contract under applicable State or local law, and must be enforceable against the taxpayer or his property under such law. In any case where a person is acting solely as a mere nominee, the real party in interest shall be considered a party to the contract.

(4) *Continuing existence of contract and its terms.* In order for a financing agreement to qualify under this paragraph, the terms of such agreement must not be substantially modified after July 24, 1969 (other than by a modification required by a Federal, State, or local agency). Among the modifications which will ordinarily be considered substantial are an increase of more than 20 percent in the amount of the loan (other than to reflect the actual costs of construction), or the term for repayment, unless such modifications are pursuant to a contract provision in effect on July 24, 1969. Changes in the rate of interest on the loan will ordinarily not be considered a substantial modification absent other factors. Even if there is a substantial modification in a financing agreement, the agreement may still qualify under this paragraph if circumstances exist which show that the modification does not reduce the taxpayer's obligation under the financing agreement.

(5) *Extent of taxpayer's obligations.* If an agreement qualifies as permanent financing under this paragraph, the completed building or buildings which constitute the underlying subject matter of the financing agreement will qualify under section 167(j)(3)(B), provided that the agreement identifies and describes the size, estimated cost, and estimated rental value of the property to be constructed, reconstructed, or erected, and the building is completed in accordance with the terms of the contract in existence on July 24, 1969. Thus, if an agreement represents a general line of credit, the agreement will not be considered a contract for permanent financing under this paragraph, since the property to be constructed is not identified. Further, if there is a substantial modification in the terms of

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the contract after July 24, 1969 (other than a modification required by a Federal, State, or local agency), only the property which was an integral part of the building described in the contract on July 24, 1969, shall qualify under this paragraph. A substantial modification in the terms of a contract which relate to the property to be constructed, reconstructed, or erected will be considered to have occurred only if the size, estimated cost, or estimated rental value of the building subject to the contract is changed by more than 20 percent.

(6) *Contracts with undetermined terms or conditions.* A financing agreement may qualify under this paragraph even though some of its terms are to be determined after July 24, 1969, provided that the determination is not within the unrestricted control of the taxpayer, and such terms are in fact determined. Similarly, a financing agreement may be considered binding upon the taxpayer even if it is subject to the happening of certain contingencies which have not occurred by July 25, 1969: *Provided,* That the happening of the contingencies is not within the unrestricted control of the taxpayer, and the contingencies in fact occur. For example, a permanent financing agreement which provides for a variable rate of interest may qualify under this paragraph.

(7) *Liability for damages.* A financing agreement will not qualify under this paragraph unless (i) the taxpayer's failure to perform would subject him to liability for damages or to a forfeiture of a down payment, commitment fee, or deposit, and (ii) the amount of such liability or forfeiture is more than nominal. If the down payment, commitment fee, or deposit is consistent with normal commercial practices in the locality, the contract may qualify under this paragraph. Thus, if a commitment fee is paid to a lender at the time a permanent financing arrangement is entered into, the fee is forfeitable if the taxpayer fails to consummate the loan, and the size of the commitment fee is consistent with normal commercial practices in the locality, the agreement may qualify as permanent financing under this paragraph even though the taxpayer is not legally obligated to consummate the loan.

[T.D. 7166, 37 FR 5241, Mar. 11, 1972; 37 FR 6400, Mar. 29, 1972]

§ 1.167(j)-5 Depreciation of used section 1250 property.

Except as provided in § 1.167(j)-6, in the case of section 1250 property acquired after July 24, 1969, the original use of which does not commence with the taxpayer, the reasonable allowance for depreciation provided by section 167(a) shall not exceed an amount computed under (a) the straight line method of depreciation, or (b) any other reasonable and consistently applied method of computing depreciation other than (1) any declining balance method, (2) the sum of the years-digits method, or (3) any other method allowable solely by reason of section 167(b)(4) or 167(j)(1)(C). Generally, a method of depreciation will be considered reasonable under this section if depreciation allowances computed in accordance with such method do not, during the first two-thirds of the useful life of the property, result in accumulated allowances at the end of any taxable year greater than the total of the accumulated allowances which would have resulted under the straight line method of depreciation. For purposes of this section, property shall be deemed to be acquired on the date when it is reduced to physical possession, or control, that is, on the date the taxpayer first bears the burdens and enjoys the benefits of ownership. For special rules with respect to used property acquired after July 24, 1969, pursuant to a binding written contract in effect on such date, see sections 167(j)(6)(C) and 1.167(j)-7(c).

[T.D. 7166, 37 FR 5243, Mar. 11, 1972]

§ 1.167(j)-6 Depreciation of used residential rental property.

In the case of section 1250 property which is residential rental property (as defined in section 167(j)(2)(B)) for the taxable year, acquired after July 24, 1969, which has an estimated useful life of 20 years or more in the hands of the taxpayer at the time of such acquisition, and the original use of which does not commence with the

taxpayer, the reasonable allowance provided by section 167(a) shall not exceed an amount computed under one of the following methods of depreciation: (a) The straight line method; (b) the declining balance method using a rate not exceeding 125 percent of the appropriate straight line rate computed without adjustment for salvage; or (c) any other reasonable and consistently applied method of computing depreciation, not including (1) the sum of the years-digits method, (2) any declining balance method using a rate greater than 125 percent of the straight line rate computed without adjustment for salvage, or (3) any other member allowable solely by reason of section 167(b)(4) or 167(j)(1)(C). A change in the computation of the allowance for depreciation with respect to used section 1250 property may be permitted or required by reason of the qualification or disqualification of such property as residential rental property under section 167(j)(2)(B). (See § 1.167(j)-3(c).) Generally, a method of depreciation will be considered reasonable under this section if depreciation allowances computed in accordance with such method do not, during the first two-thirds of the useful life of the property, result in accumulated allowances at the end of any taxable year greater than the total of the accumulated allowances which would have resulted under the declining balance method of depreciation, using a rate not exceeding 125 percent of the appropriate straight line rate computed without adjustment for salvage. For purposes of this section, property shall be deemed to be acquired when reduced to physical possession, or control, that is, on the date the taxpayer first bears the burdens and enjoys the benefits of ownership. For special rules with respect to used residential rental property acquired after July 24, 1969, pursuant to a binding written contract in effect on such date, see sections 167(j)(6)(C) and 1.167(j)-7(c).

[T.D. 7166, 37 FR 5243, Mar. 11, 1972]

§ 1.167(j)-7 Special operating rules.

(a) *Special exceptions for section 1250 property*—(1) *In general.* Under section 167(j)(6)(A), certain special rules similar to the rules contained in paragraphs (5), (9), (10), and (13) of section 48(h) are, under regulations prescribed by the Secretary or his delegate, to be applied for purposes of paragraphs (3), (4), and (5) of section 167(j). The operation of the special rules contained in section 167(j)(6)(A) is described in subparagraphs (2) through (5) of this paragraph.

(2) *Completed building rule.* If section 167(j)(3) applies to section 1250 property (generally where such property is subject to a binding written contract, or where construction, reconstruction, or erection of property has begun) section 167(j)(1) does not apply and the methods of depreciation described in section 167(b) (subject to the limitations contained in section 167(c)) are deemed to produce a reasonable allowance for depreciation. Under the completed building rule of this subparagraph, certain section 1250 property may qualify under section 167(j)(3) which, but for this subparagraph, would not qualify under such section. Under the rule of this subparagraph, if the building is not adequately identified as to size, estimated cost, or estimated rental value on July 24, 1969, but there is a contract or a permanent financing agreement which otherwise meets the requirements of § 1.167(j)-4 (b) or (c) and more than 50 percent of the cost of the completed building is subject to such contract, then the completed building will qualify under section 167(j)(3)(B). Likewise, if construction, reconstruction, or erection of property has begun before July 25, 1969, and more than 50 percent of the cost of the completed building is subject to a contract or construction plans in existence on July 24, 1969, but the building is not adequately described as to size, estimated cost, or estimated rental value on such date, all the section 1250 property in the completed building will qualify under section 167(j)(3)(A).

(3) *Transfers to be disregarded*—(i) *Transfers by death or certain transactions.* If section 1250 property or rights under a contract (which meets the requirements of paragraphs (b) and (c) of § 1.167(j)-4) are transferred in a transfer by reason of death or in a transaction described in subdivision

(ii) of this subparagraph, and such property (or the property acquired under such contract) would have qualified (but did not actually qualify) under section 167(j)(3), (4), (5), or (6)(C), in the hands of the decedent or the transferor, such property shall qualify under such sections in the hands of the transferee. For purposes of determining whether property would have qualified in the hands of the decedent or transferor, the principles contained in section 167(j)(3), (4), (5), and (6)(C), and this section apply. This subparagraph shall not apply to property placed in service by the decedent or transferor. The term "transfer by reason of death" means, for purposes of this subparagraph, a transfer of property which, in the hands of the transferee, has a basis determined under the provisions of section 1014(a) (relating to basis of property acquired from a decedent) because of the death of the transferor.

(ii) *Transactions covered.* The transactions referred to in subdivision (i) of this subparagraph are transactions as a result of which the basis of property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of any of the following provisions:

(*a*) Section 332 (relating to distributions in liquidation of an 80 percent or more controlled subsidiary corporation);

(*b*) Section 351 (relating to transfers to a corporation controlled by the transferor);

(*c*) Section 361 (relating to exchanges pursuant to certain corporate reorganizations);

(*d*) Section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings);

(*e*) Section 374(a) (relating to exchanges pursuant to certain railroad reorganizations);

(*f*) Section 721 (relating to transfers to a partnership in exchange for a partnership interest);

(*g*) Section 731 (relating to distributions by a partnership to a partner).

(iii) *Transactions to which section 334(b)(2) applies.* If property or rights under a contract are acquired in a transaction to which section 334(b)(2) (relating to certain liquidations of a subsidiary) applies, and such property (or the property acquired under such contract) would have qualified under section 167(j)(3) or 167(j)(6)(C) in the hands of the transferor corporation, then such property shall also qualify in the hands of the transferee corporation. This subparagraph shall apply only if 80 percent or more of the stock of the corporation making the distribution under section 334(b)(2) was acquired by the distributee before July 25, 1969, or pursuant to a written contract which was binding on the distributee on July 25, 1969.

(4) *Section 1250 property acquired from affiliated corporation.* If section 1250 property or rights under a contract are acquired after July 24, 1969, by a corporation which is a member of an affiliated group from another member of the same affiliated group, the acquiring corporation shall be treated as having (i) acquired the property on the date it was acquired by the other member, (ii) entered into a binding written contract for the construction, reconstruction, erection, acquisition, or permanent financing of the property on the date on which the other member entered into such a binding contract, and (iii) commenced construction, reconstruction, or erection of the property on the date on which the other member commenced such construction, reconstruction, or erection. Thus, in general, the determination of whether section 1250 property qualifies under section 167(j)(3), (4), (5), or (6)(C) in the hands of the acquiring corporation depends upon whether the property would have qualified (but did not actually qualify) under such sections in the hands of the transferor corporation. This subparagraph shall not apply to property which has been placed in service by the transferor corporation. For purposes of this subparagraph, the term "affiliated group" shall have the same meaning as in section 1504(a), except that all corporations are to be treated as includible corporations (without any exclusion under section 1504(b)). The provisions of this subparagraph shall apply whether or not the affiliated group elects to file a consolidated return.

(5) *Certain replacement property.* Under this subparagraph, section 1250 property may qualify under section 167(j)(3) or 167(j)(6)(C) if such property is placed in service to replace property which was destroyed or damaged by fire, storm, shipwreck, or other casualty, or stolen. This rule shall apply only to the extent that the cost or other basis of the replacement section 1250 property does not exceed the adjusted basis of the property which was destroyed, damaged, or stolen. The property which is replaced must have been section 1250 property in the hands of the taxpayer, and the replacement property must be similar or related in service or use to the replaced property.

(b) *Property considered as used property—*(1) *General rule.* If section 1250 property which is not property described in section 167(a) when its original use commences becomes property described in section 167(a) after July 24, 1969, such property shall not be considered property the original use of which commences with the taxpayer for purposes of section 167(j) (1) and (2) and shall be subject to the provisions of section 167(j) (4) or (5).

(2) *Example.* Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. A buys a new house in January of 1969, occupies the house as a personal residence until November of 1969, and then rents the house. The property is considered as property the original use of which does not commence with the taxpayer.

(c) *Binding contract with respect to used property.* Under section 167(j)(6)(C), sections 167(j)(4) and 167(j)(5) shall not apply in the case of section 1250 property acquired after July 24, 1969, pursuant to a written contract for the acquisition of such property, or for a substantial portion of the permanent financing thereof, which was on July 24, 1969, and at all times thereafter binding on the taxpayer. Thus, if this paragraph applies, property may be depreciated under a method of depreciation described in § 1.167(b)–0(b), such as the declining balance method using a rate not exceeding 150 percent of the appropriate straight line rate. For purposes of this paragraph, a contract for the acquisition of property or for a substantial portion of the permanent financing of property shall not be considered binding on the taxpayer unless such contract meets the requirements of paragraph (b) or (c) of § 1.167(j)–4, whichever is applicable. For purposes of this paragraph, property shall be deemed to be acquired when reduced to physical possession, or control, that is, on the date the taxpayer first bears the burdens and enjoys the benefits of ownership.

[T.D. 7166, 37 FR 5244, Mar. 11, 1972]

§ 1.167(k)–1 Depreciation of property attributable to rehabilitation expenditures.

(a) *In general.* (1) In the case of property attributable to rehabilitation expenditures incurred with respect to low-income rental housing after July 24, 1969, and before January 1, 1982, a taxpayer may elect under section 167(k) to compute the depreciation deduction provided by section 167(a) by using the straight line method, a useful life of 60 months, and no salvage value, in lieu of any other method of computing the reasonable allowance referred to in section 167(a). The expenditures must meet the conditions and limitations contained in §§ 1.167(k)–2 and 1.167(k)–3 and the election must be made as prescribed in § 1.167(k)–4. If a proper election with respect to any portion of the basis of property is in effect under section 167 (k), no deduction for depreciation or amortization shall be allowed with respect to that portion of the basis of such property under any other provision of the Code. For example, the additional first-year depreciation allowance for small business allowed under section 179 shall not be allowed with respect to that portion of the basis of property for which a proper election under section 167(k) is in effect. The provisions of this subparagraph may be illustrated by the following example:

Example. In 1970, a calendar-year taxpayer buys an existing building and spends $60,000 to rehabilitate 10 dwelling units. The property attributable to the expenditures is placed in service on January 1, 1971. If the conditions of § 1.167(k)–2 (relating to

minimum and maximum limitations) and § 1.167(k)–3 (relating to definitions) are met in 1971, the taxpayer may make an election under section 167(k) and claim a depreciation deduction of $12,000 (12/60×$60,000) for 1971.

(2) Any property attributable to expenditures which are incurred before July 25, 1969, or after December 31, 1981, will not qualify for an election under section 167(k). For purposes of determining whether rehabilitation expenditures are incurred after July 24, 1969, and before January 1, 1982, each dwelling unit (see § 1.167(k)–3(c)) shall be considered separately. An expenditure is incurred, for purposes of this section, on the date such expenditure would be considered incurred under the accrual method of accounting, regardless of the method of accounting used by the taxpayer with respect to other items of income and expense. Thus, even though a taxpayer is on the cash receipts and disbursements method of accounting, expenditures shall be considered incurred, for purposes of this section, on the date that all events have occurred which establish the fact of the taxpayer's liability for such expenditures, and the amount of such expenditures can be determined with reasonable accuracy. The method used by a taxpayer on the cash receipts and disbursements method of accounting, in determining when expenditures are incurred, will be acceptable if it accords with any generally recognized and accepted accrual basis income tax accounting principles. The method so adopted must be applied consistently by the taxpayer for purposes of this subparagraph. (See section 446(c) and § 1.446–1(c)(1)(ii).) The principles of this subparagraph may be illustrated by the following example:

Example. On June 30, 1969, A, a taxpayer on the cash receipts and disbursements method of accounting, signs a contract with a builder for the rehabilitation of an apartment house. If (under this subparagraph) any expenditures under the contract are considered incurred before July 25, 1969, property attributable to such expenditures does not qualify for the election under section 167(k).

(3) If an election under section 167(k) is made with respect to property, see sections 1245 and 1250 for treatment of gain on disposition of the property. See section 57(a)(2) for treatment of depreciation under section 167(k) as an item of tax preference, for purposes of the minimum tax contained in section 56.

(b) *Rehabilitation expenditures treated as paid or incurred by the taxpayer.* (1) Generally, the taxpayer is considered to have paid or incurred rehabilitation expenditures only if the rehabilitation is performed by him or for him in accordance with his specifications. However, where rehabilitation expenditures are paid or incurred by a person (or persons) and the taxpayer acquires the property attributable to such expenditures (or an interest therein) before such property is placed in service, the taxpayer will be treated as having paid or incurred the expenditures, and the portion of the basis of property attributable to such expenditures may be included in an election by the taxpayer under section 167(k). The rehabilitation expenditures must meet the requirements of this section and § 1.167(k)–2 (relating to minimum and maximum limitations) and § 1.167(k)–3 (relating to definitions). This paragraph shall apply only if the rehabilitated property is not placed in service during the period beginning with the date the expenditures were paid or incurred and ending on the date the taxpayer acquired an interest in the property. For example, assume that A pays or incurs rehabilitation expenditures of $10,000 with respect to an existing building on January 1, 1971, and then sells the building to B on June 1, 1971. If the property attributable to the expenditures is not placed in service by A during the period from January 1, 1971, to June 1, 1971, B will be treated as having paid or incurred the expenditures.

(2) The amount of rehabilitation expenditures treated as paid or incurred by the taxpayer under this paragraph is the lesser of—

(i) The rehabilitation expenditures paid or incurred before the date on which the taxpayer acquired an interest in the property attributable to the expenditures, or

(ii) The taxpayer's cost or other basis for the property attributable to

the rehabilitation expenditures paid or incurred before such date.

The portion of the basis of property which is not attributable to rehabilitation expenditures paid or incurred by the taxpayer may not be depreciated under section 167(k), but may be subject to depreciation under section 167(a). Thus, a portion of the basis of property may be subject to depreciation under the method provided by section 167(k) and another portion of the basis of that property may be subject to depreciation under a method provided by section 167(b). For purposes of section 167(k), property is acquired when reduced to physical possession or control, that is, on the date the taxpayer first bears the burdens and enjoys the benefits of ownership.

(3) (i) Property is placed in service on the date that it is first placed in a condition or state of readiness and availability for a specifically assigned function, whether in the production of income, in a tax-exempt activity, or in a personal activity. For purposes of determining when property attributable to rehabilitation expenditures is placed in service, each dwelling unit shall be considered separately. Rehabilitated property which is attributable solely to a single dwelling unit is placed in service on the date that dwelling unit is placed in service. Rehabilitated property which relates to more than one dwelling unit, or which relates to common areas or related facilities and is allocated to more than one dwelling unit under § 1.167(k)-2(d), will be considered as placed in service on the earliest date a significant number of such units are placed in service. For example, if a taxpayer reconstructs or replaces the roof of a building with 20 dwelling units, the property relates to the entire building and, accordingly, the new or reconstructed roof is placed in service on the earliest date a significant number of such dwelling units are placed in service. As a further example, assume that the first floor of a three-story building is operated for commercial purposes, and that the taxpayer rehabilitates the remaining two floors for dwelling units. In connection with the rehabilitation, the taxpayer constructs a parking lot for the use of the occupants of the building. The expenditures for the parking lot may be considered as rehabilitation expenditures (see § 1.167(k)-3(b)) and the property (parking lot) attributable to the expenditures allocated to dwelling units is treated as placed in service on the date the parking lot is available for use by the tenants of a significant number of such dwelling units.

(ii) If dwelling units are occupied on a rental basis at the same time that rehabilitation expenditures allocated to those units are paid or incurred, the property attributable to these expenditures will be considered placed in service on the date that the rehabilitation of such units is substantially completed.

(4) The principles of this paragraph may be illustrated by the following examples:

Example (1). A, a taxpayer using the cash receipts and disbursements method of accounting, begins the rehabilitation of a three-story building on January 11, 1971. Prior to May 1, 1971, he pays rehabilitation expenditures of $12,000, $1,000 of which is allocated to each of 12 dwellings units in accordance with the allocation rules of § 1.167(k)-2(d). On May 3, 1971, taxpayer A sells the building, the land, and the property attributable to the rehabilitation expenditures to taxpayer B for $35,000. The purchase price is allocated as follows:

Land	$8,000
Existing building	11,000
Property attributable to rehabilitation expenditures	16,000
Total purchase price	35,000

The property attributable to the rehabilitation expenditures is placed in service by B on September 5, 1971. Taxpayer B may treat a portion of the $35,000 purchase price as rehabilitation expenditures paid or incurred by him. Since the rehabilitation expenditures paid by A ($12,000) are less than the portion of the purchase price allocable to property attributable to these expenditures ($16,000), B may treat only $12,000 as rehabilitation expenditures paid or incurred by him. The excess of the purchase price allocable to rehabilitation expenditures ($16,000) over the rehabilitation expenditures paid by A ($12,000), or $4,000, does not qualify for treatment under section 167(k), but may qualify for the allowance for depreciation provided by section 167(a).

Example (2). The facts are the same as in example (1) except that the purchase price allocable to the property attributable to re-

habilitation expenditures is $10,000. Under these circumstances, taxpayer B may treat only $10,000 of A's $12,000 expenditures as rehabilitation expenditures paid or incurred by him. The excess of the rehabilitation expenditures paid by A ($12,000) over the purchase price allocable to rehabilitation expenditures ($10,000), or $2,000, does not qualify for treatment under section 167(k).

Example (3). C, a taxpayer using the cash receipts and disbursements method of accounting, begins the rehabilitation of an existing building on April 1, 1970. The building consists of five dwelling units. The tenants remain in the dwelling units during and after the rehabilitation. Assume that the units are rehabilitated individually and that unit 1 is rehabilitated first. The rehabilitation consists of painting, replacing plumbing facilities, installing light fixtures and appliances. The rehabilitation of this unit is substantially completed on May 1, 1970, and the property attributable to these expenditures is considered placed in service on that date. If the five units were rehabilitated at one time the property would be placed in service when the work was substantially completed with respect to all the units.

(c) *Election by partnership.* An election under section 167(k) with respect to property held by a partnership shall be made by the partnership. See section 703(b).

(d) *Expenditures deemed incurred before January 1, 1982.* For purposes of paragraph (a) of this section—

(1) Rehabilitation expenditures that are incurred pursuant to a binding contract entered into before January 1, 1982, are deemed to be incurred before January 1, 1982. The contract must require (i) the rehabilitation to be performed for the taxpayer in accordance with his specifications, or (ii) the taxpayer to perform the rehabilitation himself (or to have another person perform the work for him in accordance with his specifications). The contract, as of December 31, 1981, must also specifically identify the existing building (or buildings) in connection with which the rehabilitation expenditures are to be incurred, and the expenditures must be incurred in connection with that building (or buildings). A contract may be binding, for purposes of section 167(k)(3)(D) and this section, even if it is subject to the happening of certain contingencies (such as the obtaining of financing from a third party) which have not occurred by January 1, 1982. The happening of the contingencies, however, must not be within the unrestricted control of the taxpayer and the contingencies must in fact occur. In any event, a contract that does not represent a bona fide agreement negotiated at arms-length shall not be considered a binding contract for purposes of section 167(k)(3)(D). For purposes of section 167(k)(3)(D), a binding contract includes an agreement, entered into pursuant to section 8 of the United States Housing Act of 1937, between the taxpayer and the Department of Housing and Urban Development ("HUD") or a public housing agency ("PHA") providing that upon completion of rehabilitation in accordance with the taxpayer's final proposal, HUD or the PHA will enter into a housing assistance payments contract with the taxpayer. For purposes of the preceding sentence, "agreement", "final proposal", "public housing agency", and "housing assistance payments contract" have the same meaning as those terms have in 24 CFR Part 881 (regulations of the Department of Housing and Urban Development relating to substantial rehabilitation under the section 8 housing assistance payments program).

(2) Rehabilitation expenditures incurred with respect to a particular undertaking to rehabilitate low-income rental housing are deemed to be incurred before January 1, 1982, if the rehabilitation begins before that date. For purposes of determining whether rehabilitation has begun before January 1, 1982, each dwelling unit (see § 1.167(k)–3(c)) shall be considered separately. Rehabilitation begins upon the commencement of physical work at the dwelling unit, as distinguished from the beginning of, or engaging in, other preliminary activities, such as the preparation of architect's sketches. The determination of whether physical work has begun shall be based upon all the facts and circumstances of a particular case. In general, where physical work which has commenced at the site of the dwelling units before January 1, 1982, represents rehabilitation expenditures which are allocable under § 1.167(k)–2(d) to more than one dwelling unit

(such as the cost of replacing the roof of an existing structure), such work may be treated as having been done on units to which the expenditures are allocable.

(3) For purposes of paragraph (d) (1) and (2) of this section, "rehabilitation expenditures" include those treated as paid or incurred by the taxpayer by reason of paragraph (b)(1) of this section and the "taxpayer" includes the person or persons described in such paragraph (b)(1) who paid or incurred the expenditures. If paragraph (b)(1) of this section applies to property acquired from another person, the binding contract to incur the rehabilitation expenditures (but not the contract for the taxpayer to acquire the rehabilitated property) must be entered into before January 1, 1982.

[T.D. 7167, 37 FR 5232, Mar. 11, 1972, as amended by T.D. 7642, 44 FR 49448, Aug. 23, 1979]

§ 1.167(k)-2 Limitations.

(a) *In general.* The amount of rehabilitation expenditures that may be taken into account with respect to any dwelling unit shall be subject to the limitations described in paragraphs (b) and (c) of this section. Rehabilitation expenditures treated as paid or incurred by the taxpayer by reason of § 1.167(k)-1(b) shall be taken into account in applying the limitations of this section. Rehabilitation expenditures incurred before July 25, 1969, or after December 31, 1981, will be taken into account in applying the limitation of paragraph (b) of this section. In the case of a partnership, these limitations shall apply to the partnership, not to the individual partners. The taxpayer shall maintain detailed records which permit specific identification of the rehabilitation expenditures paid or incurred and which permit allocation of these expenditures to individual dwelling units in the manner prescribed in paragraph (d) of this section.

(b) *Minimum amount.* (1) Rehabilitation expenditures paid or incurred by the taxpayer in any taxable year with respect to any dwelling unit may be taken into account only if the sum of (i) such expenditures, and either (ii) the rehabilitation expenditures paid or incurred by the taxpayer with respect to such dwelling unit in the immediately preceding taxable year, or (iii) the rehabilitation expenditures paid or incurred by the taxpayer with respect to such dwelling unit in the immediately succeeding taxable year, exceeds $3,000. Thus, with respect to any dwelling unit the taxpayer must pay or incur rehabilitation expenditures of more than $3,000 over a period of 2 consecutive taxable years. See paragraph (e) of this section for special rule where no taxable year of the taxpayer includes the date on which the expenditures were paid or incurred.

(2) The principles of this paragraph may be illustrated by the following examples:

Example (1). A, a calendar-year taxpayer, spends $7,000 in 1970 to rehabilitate two dwelling units, of which $5,000 is attributable to unit 1 and $2,000 to unit 2. The expenditures qualify as rehabilitation expenditures under § 1.167(k)-3. The property attributable to the $5,000 spent on unit 1 would qualify for the election under section 167(k). The property attributable to the $2,000 spent on unit 2 may qualify only if an amount in excess of $1,000 is expended solely on unit 2 in either 1969 or 1971.

Example (2). The facts are the same as in example (1) except that in 1972 A spends $4,000 to further rehabilitate units 1 and 2. The $4,000 is allocated to the two units equally and qualifies as rehabilitation expenditures under § 1.167(k)-3. In the absence of any expenditures in 1971 or 1973, none of the property attributable to the expenditures in 1972 would qualify for an election under section 167(k).

(c) *Maximum amount.* (1) In general, the maximum amount of rehabilitation expenditures paid or incurred by the taxpayer with respect to any dwelling unit which may be taken into account under section 167 (k) is $20,000. However, in the case of rehabilitation expenditures incurred before January 1, 1976, the amount of such expenditures paid or incurred by the taxpayer with respect to any dwelling unit which may be taken into account under section 167 (k) is limited to $15,000. The rules in § 1.167(k)-1 (a) (2) shall apply in determining whether an expenditure is incurred before January 1, 1976. Property attributable to amounts in excess of $20,000 (or, if applicable, $15,000) may qualify for the

reasonable allowance provided by section 167 (a). All amounts with respect to which a proper election is filed will be taken into account in applying the limitations of this paragraph, including rehabilitation expenditures treated as paid or incurred by the taxpayer by reason of § 1.167(k)-1(b) and rehabilitation expenditures covered by an election revoked or considered revoked under § 1.167(k)-4(d).

(2) This paragraph may be illustrated by the following examples:

Example 1. B, a calendar-year taxpayer, spends the following amounts (per dwelling unit) in 4 consecutive taxable years beginning in 1970: $500, $2,000, $5,000, and $9,000. The expenditures qualify as rehabilitation expenditures under § 1.167(k)-3. All of the property attributable to the expenditures in 1971 and 1972 qualifies for an election under section 167(k). If the taxpayer makes an election for such years, property attributable to only $8,000 of the expenditures for 1973 qualifies for the election since the total qualified amount may not exceed $15,000. The $500 expenditure in 1970 is not taken into account.

Example (2). X, a calendar year taxpayer on the cash receipts and disbursements method of accounting, spends a total of $22,000 for rehabilitation of one dwelling unit in an existing building held for low-income rental housing. X would be considered, under the accrual method of accounting, to have incurred $19,000 of the expenditures in 1975 and $3,000 in 1976. The expenditures qualify as rehabilitation expenditures under § 1.167(k)-3. Because of the $15,000 limitation with respect to rehabilitation expenditures incurred before January 1, 1976, property attributable to only $15,000 of the $19,000 of expenditures incurred in 1975 qualifies for an election under section 167(k). The $4,000 of expenditures incurred in 1975 with respect to which X cannot make a valid election is not taken into account in applying the $20,000 limitation. Therefore, property attributable to the entire $3,000 of expenditures incurred in 1976 qualifies for an election under section 167(k).

(d) *Allocation rules.* (1) Expenditures which are attributable to more than one dwelling unit shall be allocated among those individual dwelling units in the same ratio as the area of each such dwelling unit bears to the total area of all dwelling units to which the expenditures are attributable. Expenditures for related facilities attributable solely to dwelling units, such as parking facilities for tenant use, shall be allocated among the dwelling units to which they relate in the same manner. Expenditures attributable to commercial units, or to related facilities attributable solely to commercial units, shall not be allocated to dwelling units. Expenditures for related facilities attributable in part to dwelling units and in part to nondwelling units shall be allocated among the particular dwelling and nondwelling units to which they relate. Expenditures attributable to common areas such as stairways, halls, and entranceways shall be allocated among the particular dwelling and nondwelling units to which they relate. In any case where the taxpayer can demonstrate the actual amount of expenditures paid or incurred with respect to a particular dwelling unit, the allocation rules of this subparagraph shall not apply to such expenditures.

(2) The principles of this paragraph may be illustrated by the following examples:

Example (1). A taxpayer spends $60,000 to replace the roof of an existing structure and to install a new heating system. There are 25 dwelling units of varying size in the structure. Unit 1 contains 1,000 square feet and unit 2 contains 2,000 square feet. The entire building contains 36,000 square feet. The dwelling units occupy 25,000 square feet, a retail store occupies 5,000 square feet, and common areas occupy the remainder. Of the 6,000 square feet of common areas, 1,000 square feet (5,000/30,000×6,000) are allocated to the commercial store and 5,000 (25,000/30,000×6,000) to the dwelling units. Since five-sixths of the total floor space (30,000/36,000) is attributable to dwelling units, the dwelling units are allocated $50,000 (⅚×$60,000) and the commercial units $10,000 (⅙×$60,000). Thus, unit 1 is allocated $2,000 (1,000/25,000×$50,000) and unit 2 is allocated $4,000 (2,000/25,000×$50,000).

Example (2). The facts are the same as in example (1) except that the entire building is devoted to dwelling units. In this case the allocation may be made without regard to the common areas. Thus, unit 1 is allocated $2,000 (1,000/30,000×$60,000), and unit 2 is allocated $4,000 (2,000/30,000×$60,000), of the rehabilitation expenditures.

Example (3). A taxpayer who owns a three-story apartment building spends $1,000 to install new paneling, carpeting, and lighting in the hallway on a floor containing five dwelling units of equal size. Each dwelling unit is allocated $200 of the

total expenditure. Since the expenditure is attributable only to the floor containing the five dwelling units, none of the expenditure is allocable to other areas of the building.

Example (4). A taxpayer spends $5,000 to install new fixtures and new window glass in a commercial store on the first floor of a five-story building. The other floors are occupied by dwelling units. None of the expenditure is allocable to the dwelling units.

Example (5). A owns a three-story apartment building and enters into a contract under which B agrees to paint 10 dwelling units of equal size in the building. The contract price is $5,000. Unless the taxpayer establishes the amount spent with respect to each unit, the expenditure will be allocated equally to each unit.

(e) *Special rule.* (1) Except as provided in paragraph (e)(2) of this section, for purposes of applying the limitations of this section, rehabilitation expenditures treated as having been paid or incurred by the taxpayer by reason of § 1.167(k)–1(b) shall be deemed to have been paid or incurred on the date on which such expenditures were actually paid or incurred (determined in accordance with the method of accounting used by the person that actually paid or incurred the expenditures). If no taxable year of the taxpayer includes such date, then the limitations of this section shall be applied by taking into account the period ending 24 full months after such date.

(2) In determining, for purposes of the $15,000 limitation described in the second sentence of paragraph (c)(1) of this section, whether a rehabilitation expenditure is incurred before January 1, 1976, a rehabilitation expenditure treated as having been paid or incurred by the taxpayer by reason of § 1.167(k)–1(b)(1) shall be deemed to have been incurred on the date the expenditure would be considered incurred under the accrual method of accounting by the person or persons who actually incurred the expenditure, regardless of the method of accounting used by that person or persons.

(3) The principles of this paragraph may be illustrated by the following example:

Example. B, a calendar-year taxpayer, uses the cash receipts and disbursements method of accounting. B spends $20,000 in 1969 and 1970 to rehabilitate a building containing four dwelling units. The expenditures are allocated to each dwelling unit equally. The $20,000 qualifies as rehabilitation expenditures under § 1.167(k)–3 and is paid in the form of progress payments on the following dates:

Aug. 20, 1969	$4,000
Mar. 1, 1970	5,000
May 1, 1970	7,000
Oct. 20, 1970	4,000

Taxpayer C purchases the building on November 10, 1970, and the property attributable to the expenditures is placed in service on December 1, 1970. Taxpayer C reports on the basis of a taxable year ending September 30 and uses the accrual method of accounting. For purposes of applying the minimum amount limitation of paragraph (b) of this section, the rehabilitation expenditures paid by B on August 20, 1969, are considered incurred in taxpayer C's taxable year ending September 30, 1969. The rehabilitation expenditures paid by B on March 1 and May 1, 1970, are considered incurred in taxpayer C's taxable year ending September 30, 1970. The expenditures paid by B on October 10, 1970, are considered incurred in taxpayer C's taxable year ending September 30, 1971. Thus, the property attributable to the expenditures in August 1969 would qualify for an election under section 167(k) since $16,000, or $4,000 per dwelling unit, was incurred within taxpayer C's two taxable years ending on September 30, 1969, and September 30, 1970. The property attributable to the expenditures deemed incurred in C's taxable year ending September 30, 1971, would also qualify.

[T.D. 7167, 37 FR 5233, Mar. 11, 1972, as amended by T.D. 7642, 44 FR 49448, Aug. 23, 1979]

§ 1.167(k)–3 Definitions.

(a) *Rehabilitation expenditures*—(1) *In general.* The term "rehabilitation expenditures" means amounts chargeable to capital account for depreciable property with a useful life of 5 years or more, in connection with the rehabilitation of an existing building for low-income rental housing. The existing building need not have been used for residential purposes prior to the rehabilitation. Expenditures attributable to a dwelling unit shall not qualify as rehabilitation expenditures unless following the completion of rehabilitation the dwelling unit is held for occupancy on a rental basis by tenants meeting the requirements of paragraph (b) of this section. Expenditures

for the purchase of land, or incurred to purchase the existing building or any interest in the building (such as a leasehold interest), do not qualify as rehabilitation expenditures. Expenditures attributable to a commercial unit, such as a grocery store, do not qualify as rehabilitation expenditures. An amount need not be actually spent on a dwelling unit or a building in order to qualify provided the expenditure is in connection with the rehabilitation of an existing building and not attributable to a commercial unit. For example, expenditures to pave a parking lot for use by the tenants could qualify. Such expenditures must meet the limitations of section 167(k)(2) and will be allocated in accordance with § 1.167(k)–2(d).

(2) *New construction distinguished.* Expenditures attributable to a building which are for new construction do not qualify as rehabilitation expenditures. Whether expenditures are attributable to the rehabilitation of an existing structure, or attributable to new construction, will be determined upon the basis of all the facts and circumstances. Expenditures will generally be considered attributable to rehabilitation if the foundation and outer walls of the existing building are retained. Where the internal structural framework of a building is replaced and one or more outer walls are also replaced, the expenditures will generally constitute new construction, even though the construction may be considered rehabilitation under local law. Other factors that may be relevant in this determination include the amount paid to acquire the existing building; and the amount of material remaining from the existing building.

(3) *Enlargement of existing building.* The total area occupied by the dwelling units in a rehabilitated building may not exceed the total area of the existing building prior to rehabilitation, and any enlargement of this area for dwelling units will be considered new construction which will not qualify as rehabilitation. Expenditures which are attributable to the construction of a related facility, such as a garage, sidewalk, or parking lot, will not be considered the enlargement of a building for dwelling units, even if such facility is physically attached to the building.

(4) *Examples.* The principles of this paragraph may be illustrated by the following examples:

Example (1). The taxpayer owns a two-story apartment building with an empty attic, which he plans to rehabilitate. In addition to rehabilitating the existing units, he constructs two new apartments in the space formerly occupied by the attic. The expenditures may qualify as rehabilitation expenditures. However, if the taxpayer adds a third story to the building, the expenditures for the third story do not qualify as rehabilitation expenditures.

Example (2). The taxpayer owns an apartment building. In addition to rehabilitating the existing structure, the taxpayer adds a new wing to the building occupied by dwelling units. The expenditures attributable to the new wing do not qualify as rehabilitation expenditures.

Example (3). The taxpayer owns an apartment building. As part of the rehabilitation of the existing structure, the taxpayer constructs a garage for the use of tenants. The expenditures attributable to the garage may qualify as rehabilitation expenditures. If the garage is used by tenants of dwelling units and other persons, an allocation of expenditures will be made.

(b) *Low-income rental housing*—(1) *In general.* (i) The term "low-income rental housing" means any dwelling unit in a building which is held for occupancy by families and individuals of low or moderate income (as defined in subparagraph (2) of this paragraph). A dwelling unit held for occupancy by families and individuals of low or moderate income may qualify as low-income rental housing even though other dwelling units in the same building are held for occupancy by persons who are not of low or moderate income. On the other hand, a dwelling unit held for occupancy by persons who are not of low or moderate income does not qualify as low-income rental housing, even though other dwelling units in the same building are held for occupancy by families and individuals of low or moderate income. If a dwelling unit fails to qualify as low-income rental housing at any time during the 60-month election period, any election with respect to any property attributable to rehabilitation expenditures allocated to such unit shall be considered revoked by the taxpay-

er. (See § 1.167(k)–4(d) for revocation of election.)

(ii) If a dwelling unit is rented for one or more periods during the taxable year, beginning after the date the property attributable to rehabilitation expenditures allocated to such unit is placed in service, it shall be considered low-income rental housing only if it is occupied by families and individuals of low or moderate income (as defined in subparagraph (2) of this paragraph) during each such period.

(iii) If a dwelling unit is not rented for some period during the taxable year, beginning after the date the property attributable to rehabilitation expenditures allocated to such unit is placed in service, it shall be considered low-income rental housing only if at all times during such period the rental at which the unit is offered indicates that such unit is held for occupancy by families and individuals of low or moderate income (as defined in subparagraph (2) of this paragraph). Generally, if the rental at which the unit is offered does not exceed 30 percent of the low or moderate income level (determined under subparagraph (2) of this paragraph), for the number of persons occupying comparable units, the unit will be considered low-income rental housing.

(2) *Definition of low or moderate income.* The occupants of a dwelling unit are considered families and individuals of low or moderate income for purposes of section 167(k) only if their adjusted income (computed in the manner prescribed in paragraph (b)(3) of this section) does not exceed 80 percent of the median income for the area, as determined with adjustments for smaller and larger families by the Secretary of Housing and Urban Development for the purposes of applying section 8(f)(1) of the United States Housing Act of 1937, as amended (42 U.S.C. 1437f(f)(1)), except that if, for purposes of applying such section, the Secretary of Housing and Urban Development establishes an income ceiling higher or lower than 80 percent of the median for the area, the higher or lower income ceiling shall apply. Notwithstanding the preceding sentence, the occupants of a dwelling unit shall not be considered as individuals and families of low or moderate income if all the occupants are students (as defined in section 151(e)(4)), no one of whom is entitled to file a joint return under section 6013. All determinations under this subparagraph shall be made as of the first day of the certification year (as defined in paragraph (b)(3) of this section).

(3) *Adjusted income.* (i) The adjusted income of a family or individual is the anticipated total annual income of the family or individual for the certification year, determined in accordance with the criteria prescribed by the Secretary of Housing and Urban Development under section 8(f)(3) of the United States Housing Act of 1937, as amended (42 U.S.C. 1437f(f)(3)), for purposes of determining whether a family is a lower-income family within the meaning of section 8(f)(1) of the Act. The adjusted income of a family or individual shall be computed solely from the income certification required by paragraph (b)(4) of this section and shall be computed within respect to the "certification year" of the person. Adjusted income is not affected by income earned or received during the certification year that is not included in the income certification. The "certification year" for any person is the 12-month period which begins on the later of (A) the date on which the property attributable to the expenditures allocated to the dwelling unit occupied by the person is placed in service (see § 1.167(k)–1(b)(3)), or (B) the date on which the person first occupies the unit on a rental basis, or signs a lease within respect to the unit, whichever occurs first. Adjusted income must be determined with respect to the actual occupants of the dwelling unit. For purposes of the preceding sentence, if any income of a family member who is not living in the dwelling unit would be taken into account under the criteria prescribed by the Secrtetary of Housing and Urban Development referred to in the first sentence of this subparagraph, that person shall be considered to be an occupant of the dwelling unit. The term "family", for purposes of section 167(k), means two or more persons related by blood, marriage, or operation of law.

(ii) The principles of this subparagraph may be illustrated by the following example:

Example. Family X first signs a lease on a rehabilitated dwelling unit on January 1, 1977, which the family first occupies on January 25, 1977. All expenditures with respect to the rehabilitation of the dwelling unit were paid or incurred by the taxpayer after December 31, 1975. The certification year for members of family X is the 12-month period beginning on January 1, 1977. All income earned by family X in 1976 is disregarded. Instead, the determination of adjusted income shall be made with respect to the total anticipated annual income of the family for the calendar year 1977, computed in accordance with the criteria prescribed by the Secretary of Housing and Urban Development referred to in the first sentence of this subparagraph.

(4) *Income certification requirement.* A taxpayer electing to compute depreciation under section 167(k) with respect to any property contained in a dwelling unit shall secure an income certification from the tenant covering each person who proposes to live in such unit after the beginning of the certification year. If a dwelling unit is subleased during the taxable year and the taxpayer elects to compute depreciation under section 167(k) with respect to any property contained in such unit, the taxpayer shall secure an income certification from the subtenant covering each person who proposes to live in the dwelling unit after the beginning of the certification year. If the dwelling unit is rented to a new tenant or subtenant during the 60-month election period, the taxpayer shall secure an income certification from the new tenant (or subtenant) covering each person who proposed to live in the unit after the beginning of the certification year. The income certification shall contain a statement of the anticipated total annual income for the certification year of each person who proposes to live in the dwelling unit during the certification year, the number of minors who propose to live in the dwelling unit during the certification year, and the anticipated total annual income of such minors, all determined in accordance with the criteria prescribed by the Secretary of Housing and Urban Development referred to in paragraph (b)(3) of this section. The income certification must be maintained by the taxpayer as part of its books and records.

(5) *Verification of income certification.* In the case of property attributable to expenditures paid or incurred after July 24, 1969, the income certification must be either—

(i) Sworn to before an officer authorized to administer oaths (such as a notary public) or

(ii) On a form which meets the following two requirements: (A) The form contains a warning that it is a criminal offense to make a willfully false statement or misrepresentation to any department or agency of the United States as to any matter within its jurisdiction. (B) The form is signed by the tenant (or subtenant) in connection with an application (or other requirement) for a subsidy, rent supplement, mortgage insurance, or other form of assistance to either the taxpayer or the tenant (or subtenant) from a department or agency of the United States.

(6) *Effective date*—(i) *In general.* Paragraph (b) (2), (3), (4), and (5) of this section applies to property attributable to expenditures which are paid or incurred after December 31, 1975. Except to the extent paragraph (b)(5) of this section applies, in the case of property attributable to expenditures paid or incurred before January 1, 1976, the rules in 26 CFR 1.167(k)-3(b) (2), (3), and (4), revised as of April 1, 1978, continue to apply.

(ii) *Transitional rule for change in certification year.* In the case of property attributable to expenditures paid or incurred after December 31, 1975, the taxpayer may determine whether the occupants (including a subtenant) of any dwelling unit are families and individuals of low or moderate income by applying all of the rules in paragraph (b) (2), (3), and (4) of this section, as in effect before being revised by T.D. 7642. However, the rules in paragraph (b)(5) of this section (as revised by T.D. 7642), relating to the verification of income certifications, shall apply. This subdivision (ii) applies only if the income certification is signed by the tenant (or subtenant) on or before June 7, 1978.

(iii) *Expenditures treated as paid or incurred by the taxpayer.* For purposes of applying this subparagraph (6), rehabilitation expenditures treated as having been paid or incurred by the taxpayer by reason of § 1.167(k)–1(b) shall be deemed to have been paid or incurred on the date on which the expenditures were actually paid or incurred, determined in accordance with the method of accounting used by the person that actually paid or incurred the expenditures.

(7) *Examples.* The principles of this paragraph may be illustrated by the following examples:

Example (1). The median family income in a particular area for a family of four, as established for the purposes of applying section 8(f)(1) of the United States Housing Act of 1937, is $12,000. During 1976, the taxpayer spends in excess of $3,000 per unit in rehabilitating three two-bedroom dwelling units, X, Y, and Z. All the units are placed in service on January 1, 1977, and are advertised for rental at $200 per month. Unit X is rented at this price to tenant A and unit Y is rented to tenant B. A and B are both married and each has two children. At the time of the signing of the lease, tenant A certifies that the A family's adjusted income for the certification year (the 12-month period beginning on the date the lease is signed), computed under paragraph (b)(3) of this section, is $9,000. Tenant B, at the time of signing the lease, certifies that the B family's adjusted income is $10,000 for the certification year. Assuming that the Secretary of Housing and Urban Development has not established an income ceiling higher or lower than 80 percent of median for the area for purposes of applying section 8(f)(1) of the United States Housing Act of 1937, the low or moderate income level for the purpose of this paragraph is $9,600 (80 percent of the $12,000 median income for the area). Since tenant A's adjusted family income of $9,000 does not exceed this amount, rehabilitation expenditures allocated to the dwelling unit rented to tenant A could qualify under section 167(k). However, the rehabilitation expenditures allocated to the dwelling unit rented to tenant B could not qualify, since tenant B's adjusted family income ($10,000) is in excess of the low or moderate income level for the area.

Example (2). The facts are the same as in Example (1). Eight months after signing the lease, tenant A receives a promotion that was not anticipated when the lease was signed. Because of the unanticipated promotion, tenant A's actual income for the certification year is $9,800, which is more than the income ceiling ($9,600). Even though A's adjusted income would not have qualified if the promotion had been anticipated when the lease was signed, the original election with respect to property contained in unit X will remain valid as long as tenant A occupies the unit. Unit Z, even though vacant throughout 1977, will be considered low-income rental housing because the rental at which the unit is offered ($2,400 per year) does not exceed $2,880, *i.e.*, 30 percent of $9,600, the low or moderate income level for a family of four.

(c) *Dwelling unit*—(1) *In general.* The term "dwelling unit" means a house or apartment used to provide living accommodations in a building or structure. It is not required that the dwelling unit be occupied subject to a lease.

(2) *Exception.* The term "dwelling unit" does not include any unit in a hotel, motel, inn, or other establishment more than one-half of the dwelling units in which are used on a transient basis. A dwelling unit is used on a transient basis if, for more than one-half of the days in which the unit is occupied on a rental basis during the taxpayer's taxable year, it is occupied by a tenant or series of tenants each of whom occupies the unit for less than 30 days. If a dwelling unit is occupied subject to a sublease for any portion of the taxable year, the determination of whether the unit is occupied on a transient basis shall be made with respect to the sublessee who occupies the unit, not with respect to the lessee.

(d) *Paid or incurred.* For the definition of "paid or incurred," see section 7701(a)(25).

[T.D. 7167, 37 FR 5235, Mar. 11, 1972, as amended by T.D. 7642, 44 FR 49449, Aug. 23, 1979]

§ 1.167(k)–4 Time and manner of making election.

(a) *Manner of election*—(1) *In general.* An election under section 167(k) shall be made by attaching a statement to the income tax return filed for the first taxable year in which the taxpayer computes the depreciation deduction using a 60-month useful life. An information statement shall be attached to the income tax return filed for each subsequent taxable year in

which the taxpayer computes depreciation under section 167(k). The 60-month election period shall begin with the date the property is placed in service, unless the taxpayer adopts an averaging convention in accordance with § 1.167(a)-10(b) which permits the use of some other date. Except as provided in subparagraph (2) of this paragraph, no election may be made until all the conditions and limitations of §§ 1.167(k)-2 and 1.167(k)-3 are satisfied.

(2) *Special rule.* The rules contained in this subparagraph shall apply only if the taxpayer does not satisfy the $3,000 minimum amount limitation of section 167(k)(2)(B) in the taxable year in which property is placed in service and in the immediately preceding taxable year. The taxpayer may make an election under section 167(k) for the taxable year in which property is placed in service, by filing the election within the time and in the manner prescribed in this section and by enclosing a separate written statement disclosing an intent to fulfill the $3,000 minimum amount limitation in the succeeding taxable year. If the taxpayer does not make an election under the preceding sentence for the taxable year the property is placed in service, an amended return to make the election may be filed for such year, provided that such amended return is filed within the time and in the manner prescribed in paragraph (c)(2) of this section. The principles of this subparagraph may be illustrated by the following example:

Example. A, a calendar-year taxpayer spends $2,000 per dwelling unit in 2 consecutive taxable years, beginning in 1970, and the expenditures qualify as rehabilitation expenditures under § 1.167(k)-3. An election under this subparagraph may be made with respect to the property placed in service in 1970, even though the income tax return for 1970 is due before any expenditures have been paid or incurred in 1971: *Provided,* That A files a statement of intent to spend more than $1,000 per dwelling unit in 1971. Alternatively, A may file an amended return for 1970.

(b) *Information required*—(1) *Election year.* The election to compute depreciation under section 167(k) with respect to any property must contain the following information:

(i) Taxpayer's name, address, and identification number.

(ii) Description of property with respect to which an election is made, and the date such property was placed in service (see § 1.167(k)-1(b)(3)).

(iii) Location and description of building being rehabilitated.

(iv) Number of dwelling units in the structure, and the number of such units occupied on a transient basis (see § 1.167(k)-3(c)(2)).

(v) Date rehabilitation expenditures were incurred (see § 1.167(k)-1(a)(2)).

(vi) Statement that all income certifications required by § 1.167(k)-3(b)(4) have been obtained.

(vii) For each dwelling unit which the taxpayer seeks to qualify as low-income housing for purposes of the election under section 167(k):

(*a*) Rehabilitation expenditures allocated to such unit (see § 1.167(k)-2(d)),

(*b*) For each period of occupancy during the taxable year, the number of occupants, the maximum income level permissible under § 1.167(k)-3(b)(2) for that number of occupants, the adjusted income of the occupants of such unit (determined solely from the income certifications required by § 1.167(k)-3(b)(4)), the method by which such income was determined, and the rent charged for such unit, and

(*c*) For each period in which such unit is vacant during the taxable year, a description of each such unit (as to number of rooms), the low- or moderate-income level in that area for the number of persons occupying comparable units, and the rental at which each vacant unit is offered.

(viii) If allocation is required under § 1.167(k)-2(d), the area occupied by dwelling units and nondwelling units.

(ix) If applicable, statement of intent to fulfill $3,000 minimum amount limitation (see § 1.167(k)-4(a)(2)).

(x) If the taxpayer is treated as having paid or incurred expenditures by reason of § 1.167(k)-1(b), the amount of such expenditures, the date the expenditures were incurred, the date the property attributable to the expenditures was placed in service, the method of accounting used by the person that made the expenditures,

and the purchase price for the property attributable to the expenditures.

(2) *Subsequent years.* For each taxable year in which depreciation is computed under section 167(k) after the taxable year of the election, the statement required by this section must state the rental charges for each occupied unit and the rental charge at which each vacant unit is offered. In addition, if any such unit is rented to a new tenant during the taxable year, such statement must also contain the following information:

(i) A statement that such tenant has signed an income certification (§ 1.167(k)-3(b)(4)), and

(ii) The number of occupants in the unit, the maximum income level permissible under § 1.167(k)-3(b)(2) for that number of occupants, and the total adjusted income of such occupants, determined solely from the income certifications required by § 1.167(k)-3(b)(4).

(c) *Time for filing election*—(1) *General rule.* In general, the election to compute depreciation under section 167(k) with respect to any property attributable to rehabilitation expenditures must be filed no later than the time prescribed by law (including extensions thereof) for filing the taxpayer's return for the taxable year in which the property is placed in service, provided that the rehabilitation expenditures meet the requirements of §§ 1.167(k)-2 and 1.167(k)-3 in that year, taking into account expenditures of the preceding taxable year for purposes of the $3,000 minimum amount limitation. The statement required for subsequent years must be filed no later than the time prescribed by law (including extensions thereof) for filing the return for such subsequent years. However, if the taxpayer does not file a timely return for the year in which the property is placed in service, the election shall be filed at the time the taxpayer files his first return for such year. For information required in the election and subsequent years, see paragraph (b) of this section. If the taxpayer fails to make an election within the time prescribed by this paragraph, no election may be made with respect to such property by the filing of an amended return or in any other manner.

(2) *Special rule.* If an election is filed with an amended return permitted by paragraph (a)(2) of this section it must be filed no later than time prescribed by law (including extensions thereof) for filing a return for the first taxable year following the year in which the property is placed in service. The principles of this subparagraph may be illustrated by the following example:

Example. A, a calendar-year taxpayer, spends the following amounts (per dwelling unit) in 4 consecutive taxable years beginning in 1970: $2,000, $3,000, $4,000, and $5,000. The expenditures qualify as rehabilitation expenditures under § 1.167(k)-3 and the property attributable to the expenditures in each of the 4 taxable years would qualify for an election under section 167(k). A does not file an election under section 167(k) for 1970 or 1971 and the property attributable to the rehabilitation expenditures for those years may qualify for depreciation allowable under section 167(a). A may make an election under section 167(k) for the property attributable to the expenditures made in 1972 and 1973.

(d) *Revocation of election*—(1) *In general.* An election under section 167(k) may be revoked by the taxpayer at any time prior to the time prescribed by law (including extensions thereof) for filing a tax return for the last taxable year in which any portion of the 60-month election period falls. Such revocation shall be made by filing a statement in writing with the district director or director of the Internal Revenue service center with which the election was filed. If an election is revoked under this paragraph, the revocation shall not affect taxable years for which a tax return was filed computing a depreciation deduction under section 167(k). The revocation shall be effective on the date specified by the taxpayer. Such revocation may apply to any property attributable to rehabilitation expenditures allocated to any dwelling unit in the building or structure or to all such property. An election revoked under this subparagraph may not be reinstated.

(2) *Failure to meet requirements of section 167(k).* An election under sec-

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tion 167(k) with respect to property attributable to a dwelling unit shall be considered revoked with respect to such property if at any time during the taxable year—

(i) Such unit is rented to (or held for occupancy by) a family or individual not meeting the definition of low or moderate income (see § 1.167(k)-3(b)(2));

(ii) More than one-half of the dwelling units in the building are rented on a transient basis (see § 1.167(k)-3(c)); or

(iii) Expenditures which are required in order to meet the $3,000 minimum amount limitation for the preceding taxable year are insufficient (see § 1.167(k)-2(b)).

The revocation shall be deemed to occur on the first day in which the dwelling unit does not meet the requirements of section 167(k) during the taxable year. Any revocation of an election under this subparagraph shall not affect prior taxable years for which a tax return computing depreciation under section 167(k) was filed if all the conditions of section 167(k) were met for those years. An election considered revoked under this subparagraph may not be reinstated.

(3) *Effect of revocation.* The taxpayer may not compute the depreciation deduction using the 60-month useful life permitted under section 167(k) for any portion of any taxable year beginning after the date on which a revocation is effective under this paragraph. The depreciation deduction allowed under section 167(k) for the taxable year in which a revocation is effective shall be the amount such deduction would have been for such year if no revocation had occurred, multiplied by a fraction consisting of (i) the number of days in the taxable year prior to the date of the revocation, over (ii) the number of days of the 60-month election period which fall within such year. The taxpayer shall continue to use the straight line method of depreciation, but shall use the estimated remaining useful life and salvage value of the property (determined without regard to section 167(k)) as of the date such revocation is deemed to occur. If the taxpayer wishes to adopt another method of depreciation following a revocation of an election, such new method is a change in a method of accounting which requires the consent of the Secretary or his delegate under section 446(e). Generally, the straight line method of depreciation using the property's remaining useful life determined without regard to section 167(k) will be the only method of depreciation which will be accepted following a revocation.

(4) *Example.* The principles of this paragraph may be illustrated by the following example:

Example. Beginning after July 24, 1969, a calendar-year taxpayer spends $5,000 per dwelling unit to rehabilitate the three dwelling units in an apartment house. The property attributable to these expenditures is placed in service on January 1, 1970. The dwelling units qualify as low-income rental housing and the taxpayer elects to compute depreciation under section 167(k). The dwelling units continue to qualify as low-income rental housing throughout 1970, 1971, and 1972. On March 15, 1973, the three units cease to qualify as low-income rental housing and the election under section 167(k) is considered revoked on that date. The amount of the depreciation deduction computed under section 167(k) for 1973 with respect to these three units is the amount such depreciation would have been absent a revocation, $3,000 ($\frac{1}{5} \times \$15,000$), multiplied by the number of days of the taxable year before the revocation, 73, over the number of days of the 60-month election period within the taxable year, 365. Thus, the depreciation deduction for 1973 under section 167(k) is $600 ($\frac{73}{365} \times \$3,000$). For the remainder of 1973, the taxpayer must compute depreciation under the straight line method, using the estimated useful life and the salvage value of the property on March 15, 1973. The adjusted basis of the property on March 15, 1973, is $5,400, the property's unadjusted basis ($15,000), minus the depreciation allowed under section 167(k) ($9,600). Assume that the property's estimated remaining useful life is 20 years and that the salvage value is $1,000. The depreciation deduction for the remainder of 1973 under section 167(a) is the amount the depreciation would have been for 1973 under the straight line method, $220 ($\frac{1}{20} \times \$4,400$), multiplied by the number of days following the revocation, 292, over the number of days of the taxable year, 365. Thus, the taxpayer would be allowed a deduction of $176 under section 167(a) for the period of 1973 following the revocation ($\frac{292}{365} \times \$220$). The depreciation allowed for 1973 with respect to the property is the sum of the depreciation computed

under section 167(k) before the revocation ($600) plus the depreciation allowed under section 167(a) after the revocation ($176), or $776.

(e) *Effective date.* The provisions of section 167(k) apply to taxable years ending after July 24, 1969. A taxpayer will be permitted to make an election or revoke an election under section 167(k) on or before June 9, 1972. The election will be permitted under this paragraph for any taxable year ending after July 24, 1969, notwithstanding the fact that the period prescribed by paragraph (c) of this section for filing an election for such taxable year has expired. The provisions of paragraph (a)(1) of this section shall apply for purposes of determining the beginning of the 60-month election period. If the taxpayer is permitted to revoke an election with respect to any property within the 90-day period specified in this paragraph, the taxpayer may adopt any method of depreciation permitted under section 167 for such property, beginning with the date the property was placed in service, using the estimated useful life of the property on such date, determined without regard to section 167(k).

(f) *Extension of time for election.* In the case of property attributable to expenditures paid or incurred after December 31, 1975, a taxpayer will be permitted to make an election under section 167(k) (and file the statement required for subsequent taxable years by paragraph (b)(2) of this section) on or before November 21, 1979, notwithstanding the fact that the period prescribed by paragraph (c) of this section for filing an election for the taxable year (or for filing the statement required for a subsequent year) has expired. For purposes of applying this paragraph (f), rehabilitation expenditures treated as having been paid or incurred by the taxpayer by reason of § 1.167(k)-1(b) shall be deemed to have been paid or incurred on the date on which the expenditures were actually paid or incurred, determined in accordance with the method of accounting used by the person that actually paid or incurred the expenditures.

[T.D. 7167, 37 FR 5237, Mar. 11, 1972, as amended by T.D. 7642, 44 FR 49450, Aug. 23, 1979]

§ 1.167(l)-1 Limitations on reasonable allowance in case of property of certain public utilities.

(a) *In general*—(1) *Scope.* Section 167(l) in general provides limitations on the use of certain methods of computing a reasonable allowance for depreciation under section 167(a) with respect to "public utility property" (see paragraph (b) of this section) for all taxable years for which a Federal income tax return was not filed before August 1, 1969. The limitations are set forth in paragraph (c) of this section for "pre-1970 public utility property" and in paragraph (d) of this section for "post-1969 public utility property." Under section 167(l), a taxpayer may always use a straight line method (or other "subsection (l) method" as defined in paragraph (f) of this section). In general, the use of a method of depreciation other than a subsection (l) method is not prohibited by section 167(l) for any taxpayer if the taxpayer uses a "normalization method of regulated accounting" (described in paragraph (h) of this section). In certain cases, the use of a method of depreciation other than a subsection (l) method is not prohibited by section 167(l) if the taxpayer used a "flow-through method of regulated accounting" described in paragraph (i) of this section) for its "July 1969 regulated accounting period" (described in paragraph (g) of this section) whether or not the taxpayer uses either a normalization or a flow-through method of regulated accounting after its July 1969 regulated accounting period. However, in no event may a method of depreciation other than a subsection (l) method be used in the case of pre-1970 public utility property unless such method of depreciation is the "applicable 1968 method" (within the meaning of paragraph (e) of this section). The normalization requirements of section 167(l) with respect to public utility property defined in section 167(l) (3) (A) pertain only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight line depreciation for comput-

ing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. Regulations under section 167(l) do not pertain to other book-tax timing differences with respect to State income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items. The rules provided in paragraph (h)(6) of this section are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated method of depreciation for cost of service purposes and the reserve amount that may be excluded from the rate base or included in no-cost capital in determining such cost of services. The formula provided in paragraph (h)(6)(ii) of this section is to be used in conjunction with the method of accounting for the reserve for deferred taxes (otherwise proper under paragraph (h)(2) of this section) in accordance with the accounting requirements prescribed or approved, if applicable, by the regulatory body having jurisdiction over the taxpayer's regulated books of account. The formula provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer. The formula serves to limit the amount of such disallowance.

(2) *Methods of depreciation.* For purposes of section 167(l), in the case of a declining balance method each different uniform rate applied to the unrecovered cost or other basis of the property is a different method of depreciation. For purposes of section 167(l), a change in a uniform rate of depreciation due to a change in the useful life of the property or a change in the taxpayer's unrecovered cost or other basis for the property is not a change in the method of depreciation. The use of "guideline lives" or "class lives" for Federal income tax purposes and different lives on the taxpayer's regulated books of account is not treated for purposes of section 167(l) as a different method of depreciation. Further, the use of an unrecovered cost or other basis or salvage value for Federal income tax purposes different from the basis or salvage value used on the taxpayer's regulated books of account is not treated as a different method of depreciation.

(3) *Application of certain other provisions to public utility property.* For rules with respect to application of the investment credit to public utility property, see section 46(e). For rules with respect to the application of the class life asset depreciation range system, including the treatment of the use of "class lives" for Federal income tax purposes and different lives on the taxpayer's regulated books of account, see § 1.167(a)-11 and § 1.167(a)-12.

(4) *Effect on agreements under section 167(d).* If the taxpayer has entered into an agreement under section 167(d) as to any public utility property and such agreement requires the use of a method of depreciation prohibited by section 167(l), such agreement shall terminate as to such property. The termination, in accordance with this subparagraph, shall not affect any other property (whether or not public utility property) covered by the agreement.

(5) *Effect of change in method of depreciation.* If, because the method of depreciation used by the taxpayer with respect to public utility property is prohibited by section 167(l), the taxpayer changes to a method of depreciation not prohibited by section 167(l), then when the change is made the unrecovered cost or other basis shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time.

(b) *Public utility property*—(1) *In general.* Under section 167(l)(3)(A), property is "public utility property" during any period in which it is used predeominantly in a "section 167(l) public utility activity". The term "section 167(l) public utility activity" means the trade or business of the furnishing or sale of—

(i) Electrical energy, water, or sewage disposal services,

(ii) Gas or steam through a local distribution system,

(iii) Telephone services,

(iv) Other communication services (whether or not telephone services) if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701), or

(v) Transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, are regulated, i.e., have been established or approved by a regulatory body described in section 167(l)(3)(A). The term "regulatory body described in section 167(l)(3)(A)" means a State (including the District of Columbia) or political subdivision thereof, any agency or instrumentality of the United States, or a public service or public utility commission or other body of any State or political subdivision thereof similar to such a commission. The term "established or approved" includes the filing of a schedule of rates with a regulatory body which has the power to approve such rates, even though such body has taken no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer involved.

(2) *Classification of property.* If property is not used solely in a section 167(l) public utility activity, such property shall be public utility property if its predominant use is in a section 167(l) public utility activity. The predominant use of property for any period shall be determined by reference to the proper accounts to which expenditures for such property are chargeable under the system of regulated accounts required to be used for the period for which the determination is made and in accordance with the principles of § 1.46-3(g)(4) (relating to credit for investment in certain depreciable property). Thus, for example, for purposes of determining whether property is used predominantly in the trade or business of the furnishing or sale of transportation of gas by pipeline, or furnishing or sale of gas through a local distribution system, or both, the rules prescribed in § 1.46-3(g)(4) apply, except that accounts 365 through 371, inclusive (Transmission Plant), shall be added to the accounts enumerated in subdivision (i) of such paragraph (g)(4).

(c) *Pre-1970 public utility property*—(1) *Definition.* (i) Under section 167(l)(3)(B), the term "pre-1970 public utility property" means property which was public utility property at any time before January 1, 1970. If a taxpayer acquires pre-1970 public utility property, such property shall be pre-1970 public utility property in the hands of the taxpayer even though such property may have been acquired by the taxpayer in an arm's-length cash sale at fair market value or in a tax-free exchange. Thus, for example, if corporation X which is a member of the same controlled group of corporations (within the meaning of section 1563(a)) as corporation Y sells pre-1970 public utility property to Y, such property is pre-1970 public utility property in the hands of Y. The result would be the same if X and Y were not members of the same controlled group of corporations.

(ii) If the basis of public utility property acquired by the taxpayer in a transaction is determined in whole or in part by reference to the basis of any of the taxpayer's pre-1970 public utility property by reason of the application of any provision of the code, and if immediately after the transaction the adjusted basis of the property acquired is less than 200 percent of the adjusted basis of such pre-1970 public utility property immediately before the transaction, the property acquired is pre-1970 public utility property.

(2) *Methods of depreciation not prohibited.* Under section 167(l)(1), in the case of pre-1970 public utility property, the term "reasonable allowance" as used in section 167(a) means, for a taxable year for which a Federal income tax return was not filed before August 1, 1969, and in which such property is public utility property, an allowance (allowable without regard to section 167(l)) computed under—

(i) A subsection (l) method, or

(ii) The applicable 1968 method (other than a subsection (1) method) used by the taxpayer for such property, but only if—

(*a*) The taxpayer uses in respect of such taxable year a normalization method of regulated accounting for such property,

(*b*) The taxpayer used a flow-through method of regulated accounting for such property for its July 1969 regulated accounting period, or

(*c*) The taxpayer's first regulated accounting period with respect to such property is after the taxpayer's July 1969 regulated accounting period and the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period for public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service. See paragraph (e)(5) of this section for determination of same (or similar) kind.

(3) *Flow-through method of regulated accounting in certain cases.* See paragraph (e)(6) of this section for treatment of certain taxpayers with pending applications for change in method of accounting as being deemed to have used a flow-through method of regulated accounting for the July 1969 regulated accounting period.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). Corporation X, a calendar-year taxpayer subject to the jurisdiction of a regulatory body described in section 167(l)(3)(A), used the straight line method of deprecation (a subsection (l) method) for all of its public utility property for which depreciation was allowable on its Federal income tax return for 1967 (the latest taxable year for which X, prior to August 1, 1969, filed a return). Assume that under paragraph (e) of this section, X's applicable 1968 method is a subsection (l) method with respect to all of its public utility property. Thus, with respect to its pre-1970 public utility property, X may only use a straight line method (or any other subsection (l) method) of depreciation for all taxable years after 1967.

Example (2). Corporation Y, a calendar-year taxpayer subject to the jurisdiction of the Federal Power Commission, is engaged exclusively in the transportation of gas by pipeline. On its Federal income tax return for 1967 (the latest taxable year for which Y, prior to August 1, 1969, filed a return), Y used the declining balance method of depreciation using a rate of 150 percent of the straightline rate for all of its nonsection 1250 public utility property with respect to which depreciation was allowable. Assume that with respect to all of such property, Y's applicable 1968 method under paragraph (e) of this section is such 150 percent declining balance method. Assume that Y used a normalization method of regulated accounting for all relevant regulated accounting periods. If Y continues to use a normalization method of regulated accounting, Y may compute its reasonable allowance for purposes of section 167(a) using such 150 percent declining balance method for its nonsection 1250 pre-1970 public utility property for all taxable years beginning with 1968, provided the use of such method is allowable without regard to section 167(l). Y may also use a subsection (l) method for any of such pre-1970 public utility property for all taxable years beginning after 1967. However, because each different uniform rate applied to the basis of the property is a different method of depreciation, Y may not use a declining balance method of depreciation using a rate of twice the straight line rate for any of such pre-1970 public utility property for any taxable year beginning after 1967.

Example (3). Assume the same facts as in example (2) except that with respect to all of its nonsection 1250 pre-1970 public utility property accounted for in its July 1969 regulated accounting period Y used a flow-through method of regulated accounting for such period. Assume further that such property is the property on the basis of which the applicable 1968 method is established for pre-1970 public utility property of the same kind, but having a first regulated accounting period after the taxpayer's July 1969 regulated accounting period. Beginning with 1968, with respect to such property Y may compute its reasonable allowance for purposes of section 167(a) using the declining balance method of depreciation and a rate of 150 percent of the straight line rate, whether it uses a normalization or flow-through method of regulated accounting after its July 1969 regulated accounting period, provided the use of such method is allowable without regard to section 167(l).

(d) *Post-1969 public utility property*—(1) *In general.* Under section 167(l)(3)(C), the term "post-1969 public utility property" means any public utility property which is not pre-1970 public utility property.

(2) *Methods of depreciation not prohibited.* Under section 167(l)(2), in the case of post-1969 public utility property, the term "reasonable allowance" as used in section 167(a) means, for a taxable year, an allowance (allowable

without regard to section 167(l)) computed under—

(i) A subsection (l) method,

(ii) A method of depreciation otherwise allowable under section 167 if, with respect to the property, the taxpayer uses in respect of such taxable year a normalization method of regulated accounting, or

(iii) The taxpayer's applicable 1968 method (other than a subsection (l) method) with respect to the property in question, if the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period for the property of the same (or similar) kind most recently placed in service, provided that the property in question is not property to which an election under section 167(l)(4)(A) applies. See § 1.167(l)(2) for rules with respect to an election under section 167(l)(4)(A). See paragraph (e)(5) of this section for definition of same (or similar) kind.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). Corporation X is engaged exclusively in the trade or business of the transportation of gas by pipeline and is subject to the jurisdiction of the Federal Power Commission. With respect to all its public utility property, X's applicable 1968 method (as determined under paragraph (e) of this section) is the straight line method of depreciation. X may determine its reasonable allowance for depreciation under section 167(a) with respect to its post-1969 public utility property under a straight line method (or other subsection (l) method) or, if X uses a normalization method of regulated accounting, any other method of depreciation, provided that the use of such other method is allowable under section 167 without regard to section 167(l).

Example (2). Assume the same facts as in example (1) except that with respect to all of X's post-1969 public utility property the applicable 1968 method (as determined under paragraph (e) of this section) is the declining balance method using a rate of 150 percent of the straight line rate. Assume further that all of X's pre-1970 public utility property was accounted for in its July 1969 regulated accounting period, and that X used a flow-through method of regulated accounting for such period. X may determine its reasonable allowance for depreciation under section 167 with respect to its post-1969 public utility property by using the straight line method of depreciation (or any other subsection (l) method), by using any method otherwise allowable under section 167 (such as a declining balance method) if X uses a normalization method of regulated accounting, or, by using the declining balance method using a rate of 150 percent of the straight line rate, whether or not X uses a normalization or a flow-through method of regulated accounting.

(e) *Applicable 1968 method*—(1) *In general.* Under section 167(l)(3)(D), except as provided in subparagraphs (3) and (4) of this paragraph, the term "applicable 1968 method" means with respect to any public utility property—

(i) The method of depreciation properly used by the taxpayer in its Federal income tax return with respect to such property for the latest taxable year for which a return was filed before August 1, 1969,

(ii) If subdivision (i) of this subparagraph does not apply, the method of depreciation properly used by the taxpayer in its Federal income tax return for the latest taxable year for which a return was filed before August 1, 1969, with respect to public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service before the end of such latest taxable year, or

(iii) If neither subdivision (i) nor (ii) of this subparagraph applies, a subsection (l) method.

If, on or after August 1, 1969, the taxpayer files an amended return for the taxable year referred to in subdivisions (i) and (ii) of this subparagraph, such amended return shall not be taken into consideration in determining the applicable 1968 method. The term "applicable 1968 method" if such new method results to any public utility property, for the year of change and subsequent years, a method of depreciation otherwise allowable under section 167 to which the taxpayer changes from an applicable 1968 method if such new method results in a lesser allowance for depreciation for such property under section 167 in the year of change and the taxpayer secures the Commissioner's consent to the change in accordance with the procedures of section 446(e) and § 1.446-1.

(2) *Placed in service.* For purposes of this section, property is placed in serv-

ice on the date on which the period for depreciation begins under section 167. See, for example, § 1.167(a)-10(b) and § 1.167(a)-11(c)(2). If under an averaging convention property which is placed in service (as defined in § 1.46-3(d)(ii)) by the taxpayer on different dates is treated as placed in service on the same date, then for purposes of section 167(l) the property shall be treated as having been placed in service on the date the period for depreciation with respect to such property would begin under section 167 absent such averaging convention. Thus, for example, if, except for the fact that the averaging convention used assumes that all additions and retirements made during the first half of the year were made on the first day of the year, the period of depreciation for two items of public utility property would begin on January 10 and March 15, respectively, then for purposes of determining the property of the same (or similar) kind most recently placed in service, such items of property shall be treated as placed in service on January 10 and March 15, respectively.

(3) *Certain section 1250 property.* If a taxpayer is required under section 167(j) to use a method of depreciation other than its applicable 1968 method with respect to any section 1250 property, the term "applicable 1968 method" means the method of depreciation allowable under section 167(j) which is the most nearly comparable method to the applicable 1968 method determined under subparagraph (1) of this paragraph. For example, if the applicable 1968 method on new section 1250 property is the declining balance method using 200 percent of the straight line rate, the most nearly comparable method allowable for new section 1250 property under section 167(j) would be the declining balance method using 150 percent of the straight line rate. If the applicable 1968 method determined under subparagraph (1) of this paragraph is the sum of the years-digits method, the term "most nearly comparable method" refers to any method of depreciation allowable under section 167(j).

(4) *Applicable 1968 method in certain cases.* (i)(*a*) Under section 167(l)(3)(E), if the taxpayer evidenced within the time and manner specified in (*b*) of this subdivision (i) the intent to use a method of depreciation under section 167 (other than its applicable 1968 method as determined under subparagraph (1) or (3) of this paragraph or a subsection (l) method) with respect to any public utility property, such method of depreciation shall be deemed to be the taxpayer's applicable 1968 method with respect to such public utility property and public utility property of the same (or most similar) kind subsequently placed in service.

(*b*) Under this subdivision (i), the intent to use a method of depreciation under section 167 is evidenced—

(*1*) By a timely application for permission for a change in method of accounting filed by the taxpayer before August 1, 1969, or

(*2*) By the use of such method of depreciation in the computation by the taxpayer of its tax expense for purposes of reflecting operating results in its regulated books of account for its July 1969 regulated accounting period, as established in the manner prescribed in paragraph (g)(1) (i), (ii), or (iii) of this section.

(ii) (*a*) If public utility property is acquired in a transaction in which its basis in the hands of the transferee is determined in whole or in part by reference to its basis in the hands of the transferor by reason of the application of any provision of the Code, or in a transfer (including any purchase for cash or in exchange) from a related person, then in the hands of the transferee the applicable 1968 method with respect to such property shall be determined by reference to the treatment in respect of such property in the hands of the transferor.

(*b*) For purposes of this subdivision (ii), the term "related person" means a person who is related to another person if either immediately before or after the transfer—

(*1*) The relationship between such persons would result in a disallowance of losses under section 267 (relating to disallowance of losses, etc., between related taxpayers) or section 707(b) (relating to losses disallowed, etc., between partners and controlled partner-

ships) and the regulations thereunder, or

(2) Such persons are members of the same controlled group of corporations, as defined in section 1563(a) (relating to definition of controlled group of corporations), except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a) and the regulations thereunder.

(5) *Same or similar.* The classification of property as being of the same (or similar) kind shall be made by reference to the function of the public utility to which the primary use of the property relates. Property which performs the identical function in the identical manner shall be treated as property of the same kind. The determination that property is of a similar kind shall be made by reference to the proper account to which expenditures for the property are chargeable under the system of regulated accounts required to be used by the taxpayer for the period in which the property in question was acquired. Property, the expenditure for which is chargeable to the same account, is property of the most similar kind. Property, the expenditure for which is chargeable to an account for property which serves the same general function, is property of a similar kind. Thus, for example, if corporation X, a natural gas company, subject to the jurisdiction of the Federal Power Commission, had property properly chargeable to account 366 (relating to transmission plant structures and improvements) acquired an additional structure properly chargeable to account 366, under the uniform system of accounts prescribed for natural gas companies (class A and class B) by the Federal Power Commission, effective September 1, 1968, the addition would constitute property of the same kind if it performed the identical function in the identical manner. If, however, the addition did not perform the identical function in the identical manner, it would be property of the most similar kind.

(6) *Regulated method of accounting in certain cases.* Under section 167(l)(4)(B), if with respect to any pre-1970 public utility property the taxpayer filed a timely application for change in method of accounting referred to in subparagraph (4)(i)(*b*)(*1*) of this paragraph and with respect to property of the same (or similar) kind most recently placed in service the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period, then for purposes of section 167(l)(1)(B) and paragraph (c) of this section the taxpayer shall be deemed to have used a flow-through method of regulated accounting with respect to such pre-1970 public utility property.

(7) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). Corporation X is a calendar-year taxpayer. On its Federal income tax return for 1967 (the latest taxable year for which X, prior to August 1, 1969, filed a return) X used a straight line method of depreciation with respect to certain public utility property placed in service before 1965 and used the declining balance method of depreciation using 200 percent of the straight line rate (double declining balance) with respect to the same kind of public utility property placed in service after 1964. In 1968 and 1970, X placed in service additional public utility property of the same kind. The applicable 1968 method with respect to the above described public utility property is shown in the following chart:

Property held in 1970	Placed in service	Method on 1967 return	Applicable 1968 method
Group 1	Before 1965	Straight line	Straight line.
Group 2	After 1964 and before 1968.	Double declining balance.	Double declining balance.
Group 3	After 1967 and before 1969.		Do.
Group 4	After 1968		Do.

Example (2). Corporation Y is a calendar-year taxpayer engaged exclusively in the trade or business of the furnishing of electrical energy. In 1954, Y placed in service hydroelectric generators and for all purposes Y has taken straight line depreciation with respect to such generators. In 1960, Y placed in service fossil fuel generators and for all purposes since 1960 has used the declining balance method of depreciation using a rate of 150 percent of the straight line rate (computed without reduction for salvage) with respect to such generators. After 1960 and before 1970 Y did not place in service any generators. In 1970, Y placed

in service additional hydroelectric generators. The applicable 1968 method with respect to the hydroelectric generators placed in service in 1970 would be the straight line method because it was the method used by Y on its return for the latest taxable year for which Y filed a return before August 1, 1969, with respect to property of the same kind (i.e., hydroelectric generators) most recently placed in service.

Example (3). Assume the same facts as in example (2), except that the generators placed in service in 1970 were nuclear generators. The applicable 1968 method with respect to such generators is the declining balance method using a rate of 150 percent of the straight line rate because, with respect to property of the most similar kind (fossil fuel generators) most recently placed in service, Y used such declining balance method on its return for the latest taxable year for which it filed a return before August 1, 1969.

(f) *Subsection (l) method.* Under section 167(l)(3)(F), the term "subsection (l) method" means a reasonable and consistently applied ratable method of computing depreciation which is allowable under section 167(a), such as, for example, the straight line method or a unit of production method or machine-hour method. The term "subsection (l) method" does not include any declining balance method (regardless of the uniform rate applied), sum of the years-digits method, or method of depreciation which is allowable solely by reason of section 167(b)(4) or (j)(1)(C).

(g) *July 1969 regulated accounting period*—(1) *In general.* Under section 167(l)(3)(I), the term "July 1969 regulated accounting period" means the taxpayer's latest accounting period ending before August 1, 1969, for which the taxpayer regularly computed, before January 1, 1970, its tax expense for purposes of reflecting operating results in its regulated books of account. The computation by the taxpayer of such tax expense may be established by reference to the following:

(i) The most recent periodic report of a period ending before August 1, 1969, required by a regulatory body described in section 167(l)(3)(A) having jurisdiction over the taxpayer's regulated books of account which was filed with such body before January 1, 1970 (whether or not such body has jurisdiction over rates).

(ii) If subdivision (i) of this subparagraph does not apply, the taxpayer's most recent report to its shareholders for a period ending before August 1, 1969, but only if such report was distributed to the shareholders before January 1, 1970, and if the taxpayer's stocks or securities are traded in an established securities market during such period. For purposes of this subdivision, the term "established securities market" has the meaning assigned to such term in § 1.453-3(d)(4).

(iii) If subdivisions (i) and (ii) of this subparagraph do not apply, entries made to the satisfaction of the district director before January 1, 1970, in its regulated books of account for its most recent accounting period ending before August 1, 1969.

(2) *July 1969 method of regulated accounting in certain acquisitions.* If public utility property is acquired in a transaction in which its basis in the hands of the transferee is determined in whole or in part by reference to its basis in the hands of the transferor by reason of the application of any provision of the Code, or in a transfer (including any purchase for cash or in exchange) from a related person, then in the hands of the transferee the method of regulated accounting for such property's July 1969 regulated accounting period shall be determined by reference to the treatment in respect of such property in the hands of the transferor. See paragraph (e)(4)(ii) of this section for definition of "related person".

(3) *Determination date.* For purposes of section 167(l), any reference to a method of depreciation under section 167(a), or a method of regulated accounting, taken into account by the taxpayer in computing its tax expense for its July 1969 regulated accounting period shall be a reference to such tax expense as shown on the periodic report or report to shareholders to which subparagraph (1) (i) or (ii) of this paragraph applies or the entries made on the taxpayer's regulated books of account to which subparagraph (1)(iii) of this paragraph applies. Thus, for example, assume that regulatory body A having jurisdiction

over public utility property with respect to X's regulated books of account requires X to reflect its tax expense in such books using the same method of depreciation which regulatory body B uses for determining X's cost of service for ratemaking purposes. If in 1971, in the course of approving a rate change for X, B retroactively determines X's cost of service for ratemaking purposes for X's July 1969 regulated accounting period using a method of depreciation different from the method reflected in X's regulated books of account as of January 1, 1970, the method of depreciation used by X for its July 1969 regulated accounting period would be determined without reference to the method retroactively used by B in 1971.

(h) *Normalization method of accounting*—(1) *In general.* (i) Under section 167(l), a taxpayer uses a normalization method of regulated accounting with respect to public utility property—

(*a*) If the same method of depreciation (whether or not a subsection (l) method) is used to compute both its tax expense and its depreciation expense for purposes of establishing cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(*b*) If to compute its allowance for depreciation under section 167 it uses a method of depreciation other than the method it used for purposes described in (*a*) of this subdivision, the taxpayer makes adjustments consistent with subparagraph (2) of this paragraph to a reserve to reflect the total amount of the deferral of Federal income tax liability resulting from the use with respect to all of its public utility property of such different methods of depreciation.

(ii) In the case of a taxpayer described in section 167(l) (1) (B) or (2) (C), the reference in subdivision (i) of this subparagraph shall be a reference only to such taxpayer's "qualified public utility property". See § 1.167(l)-2(b) for definition of "qualified public utility property".

(iii) Except as provided in this subparagraph, the amount of Federal income tax liability deferred as a result of the use of different method of depreciation under subdivision (i) of this subparagraph is the excess (computed without regard to credits) of the amount the tax liability would have been had a subsection (l) method been used over the amount of the actual tax liability. Such amount shall be taken into account for the taxable year in which such different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (l) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover (as determined under section 172) to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (l) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

(2) *Adjustments to reserve.* (i) The taxpayer must credit the amount of deferred Federal income tax determined under subparagraph (1) (i) of this paragraph for any taxable year to a reserve for deferred taxes, a depreciation reserve, or other reserve account. The taxpayer need not establish a separate reserve account for such amount but the amount of deferred tax determined under subparagraph (1) (i) of this paragraph must be accounted for in such a manner so as to be readily identifiable. With respect to any account, the aggregate amount allocable to deferred tax under section 167(l) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation under subparagraph (1) (i) of this paragraph. An additional exception is that the aggregate amount allocable to deferred tax under section 167(l) may be properly adjusted to reflect asset retirements or the expiration of the period for depreciation used in de-

termining the allowance for depreciation under section 167(a).

(ii) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Corporation X is exclusively engaged in the transportation of gas by pipeline subject to the jurisdiction of the Federal Power Commission. With respect to its post-1969 public utility property, X is entitled under section 167(l)(2)(B) to use a method of depreciation other than a subsection (l) method if it uses a normalization method of regulated accounting. With respect to such property, X has not made any election under § 1.167(a)-11 (relating to depreciation based on class lives and asset depreciation ranges). In 1972, X places in service public utility property with an unadjusted basis of $2 million, and an estimated useful life of 20 years. X uses the declining balance method of depreciation with a rate twice the straight line rate. If X uses a normalization method of regulated accounting, the amount of depreciation allowable under section 167(a) with respect to such property for 1972 computed under the double declining balance method would be $200,000. X computes its tax expense and depreciation expense for purposes of determining its cost of service for rate-making purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation (a subsection (l) method). A depreciation allowance computed in this manner is $100,000. The excess of the depreciation allowance determined under the double declining balance method ($200,000) over the depreciation expense computed using the straight line method ($100,000) is $100,000. Thus, assuming a tax rate of 48 percent, X used a normalization method of regulated accounting for 1972 with respect to property placed in service that year if for 1972 it added to a reserve $48,000 as taxes deferred as a result of the use by X of a method of depreciation for Federal income tax purposes different from that used for establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account.

Example (2). Assume the same facts as in example (1), except that X elects to apply § 1.167(a)-11 with respect to all eligible property placed in service in 1972. Assume further that all property X placed in service in 1972 is eligible property. One hudnred percent of the asset guideline period for such property is 22 years and the asset depreciation range is from 17.5 years to 26.5 years. X uses the double declining balance method of depreciation, selects an asset depreciation period of 17.5 years, and applies the half-year convention (described in § 1.167(a)-11(c) (2) (iii)). In 1972, the depreciation allowable under section 167(a) with respect to property placed in service in 1972 is $114,285 (determined without regard to the normalization requirements in § 1.167(a)-11(b) (6) and in section 167(l)). X computes its tax expense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation (a subsection (l) method), an estimated useful life of 22 years (that is, 100 percent of the asset guideline period), and the half-year convention. A depreciation allowance computed in this manner is $45,454. Assuming a tax rate of 48 percent, the amount that X must add to a reserve for 1972 with respect to property placed in service that year in order to qualify as using a normalization method of regulated accounting under section 167(l) (3) (G) is $27,429 and the amount in order to satisfy the normalization requirements of § 1.167(a)-11(b) (6) is $5,610. X determined such amounts as follows:

(1) Depreciation allowance on tax return (determined without regard to section 167(l) and § 1.167(a)-11(b) (6))	$114,285
(2) Line (1), recomputed using a straight line method	57,142
(3) Difference in depreciation allowance attributable to different methods (line (1) minus line (2))	$57,143
(4) Amount to add to reserve under this paragraph (48 percent of line (3))	27,429
(5) Amount in line (2)	$57,142
(6) Line (5), recomputed by using an estimated useful life of 22 years and the half-year convention	45,454
(7) Difference in depreciation allowance attributable to difference in depreciation periods	$11,688
(8) Amount to add to reserve under § 1.167(a)-11(b) (6) (ii) (48 percent of line (7))	5,610

If, for its depreciation expense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, X had used a period in excess of the asset guideline period of 22 years, the total amount in lines (4) and (8) in this example would not be changed.

Example (3). Corporation Y, a calendar-year taxpayer which is engaged in furnishing electrical energy, made the election provided by section 167(l) (4) (a) with respect to its "qualified public utility property" (as defined in § 1.167(l)-2(b)). In 1971, Y placed in service qualified public utility property which had an adjusted basis of $2 million, estimated useful life of 20 years, and no salvage value. With respect to property of the same kind most recently placed in service, Y used a flow-through method of regulated ac-

counting for its July 1969 regulated accounting period and the applicable 1968 method is the declining balance method of depreciation using 200 percent of the straight line rate. The amount of depreciation allowable under the double declining balance method with respect to the qualified public utility property would be $200,000. Y computes its tax expense and depreciation expense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation. A depreciation allowance with respect to the qualified public utility property determined in this manner is $100,000. The excess of the depreciation allowance determined under the double declining balance method ($200,000) over the depreciation expense computed using the straight line method ($100,000) is $100,000. Thus, assuming a tax rate of 48 percent, Y used a normalization method of regulated accounting for 1971 if for 1971 it added to a reserve $48,000 as tax deferred as a result of the use by Y of a method of depreciation for Federal income tax purposes with respect to its qualified public utility property which method was different from that used for establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account for such property.

Example (4). Corporation Z, exclusively engaged in a public utility activity did not use a flow-through method of regulated accounting for its July 1969 regulated accounting period. In 1971, a regulatory body having jurisdiction over all of Z's property issued an order applicable to all years beginning with 1968 which provided, in effect, that Z use an accelerated method of depreciation for purposes of section 167 and for determining its tax expenses for purposes of reflecting operating results in its regulated books of account. The order further provided that Z normalize 50 percent of the tax deferral resulting from the use of the accelerated method of depreciation and that Z flow-through 50 percent of the tax deferral resulting therefrom. Under section 167(l), the method of accounting provided in the order would not be a normalization method of regulated accounting because Z would not be permitted to normalize 100 percent of the tax deferral resulting from the use of an accelerated method of depreciation. Thus, with respect to its public utility property for purposes of section 167, Z may only use a subsection (l) method of depreciation.

Example (5). Assume the same facts as in example (4) except that the order of the regulatory body provided, in effect, that Z normalize 100 percent of the tax deferral with respect to 50 percent of its public utility property and flow-through the tax savings with respect to the other 50 percent of its property. Because the effect of such an order would allow Z to flow-through a portion of the tax savings resulting from the use of an accelerated method of depreciation, Z would not be using a normalization method of regulated accounting with respect to any of its properties. Thus, with respect to its public utility property for purposes of section 167, Z may only use a subsection (l) method of depreciation.

(3) *Establishing compliance with normalization requirements in respect of operating books of account.* The taxpayer may establish compliance with the requirement in subparagraph (1)(i) of this paragraph is respect of reflecting operating results, and adjustments to a reserve, in its operating books of account by reference to the following:

(i) The most recent periodic report for a period beginning before the end of the taxable year, required by a regulatory body described in section 167(l)(3)(A) having jurisdiction over the taxpayer's regulated operating books of account which was filed with such body before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for such taxable year (whether or not such body has jurisdiction over rates).

(ii) If subdivision (i) of this subparagraph does not apply, the taxpayer's most recent report to its shareholders for the taxable year but only if (*a*) such report was distributed to the shareholders before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for the taxable year and (*b*) the taxpayer's stocks or securities are traded in an established securities market during such taxable year. For purposes of this subdivision, the term "established securities market" has the meaning assigned to such term in § 1.453-3(d)(4).

(iii) If neither subdivision (i) nor (ii) of this subparagraph applies, entries made to the satisfaction of the district director before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for the taxable year in its regulated books of account for its most recent period beginning before the end of such taxable year.

(4) *Establishing compliance with normalization requirements in computing cost of service for ratemaking purposes.* (i) In the case of a taxpayer which used a flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter, with respect to all or a portion of its pre-1970 public utility property, if a regulatory body having jurisdiction to establish the rates of such taxpayer as to such property (or a court which has jurisdiction over such body) issues an order of general application (or an order of specific application to the taxpayer) which states that such regulatory body (or court) will permit a class of taxpayers of which such taxpayer is a member (or such taxpayer) to use the normalization method of regulated accounting to establish cost of service for ratemaking purposes with respect to all or a portion of its public utility property, the taxpayer will be presumed to be using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to the public utility property to which such order applies. In the event that such order is in any way conditional, the preceding sentence shall not apply until all of the conditions contained in such order which are applicable to the taxpayer have been fulfilled. The taxpayer shall establish to the satisfaction of the Commissioner or his delegate that such conditions have been fulfilled.

(ii) In the case of a taxpayer which did not use the flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter (including a taxpayer which used a subsection (l) method of depreciation to compute its allowance for depreciation under section 167(a) and to compute its tax expense for purposes of reflecting operating results in its regulated books of account), with respect to any of its public utility property, it will be presumed that such taxpayer is using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to its post-1969 public utility property. The presumption described in the preceding sentence shall not apply in any case where there is (*a*) an expression of intent (regardless of the manner in which such expression of intent is indicated) by the regulatory body (or bodies), having jurisdiction to establish the rates of such taxpayer, which indicates that the policy of such regulatory body is in any way inconsistent with the use of the normalization method of regulated accounting by such taxpayer or by a class of taxpayers of which such taxpayer is a member, or (*b*) a decision by a court having jurisdiction over such regulatory body which decision is in any way inconsistent with the use of the normalization method of regulated accounting by such taxpayer or a class of taxpayers of which such taxpayer is a member. The presumption shall be applicable on January 1, 1970, and shall, unless rebutted, be effective until an inconsistent expression of intent is indicated by such regulatory body or by such court. An example of such an inconsistent expression of intent is the case of a regulatory body which has, after the July 1969 regulated accounting period and before January 1, 1970, directed public utilities subject to its ratemaking jurisdiction to use a flow-through method of regulated accounting, or has issued an order of general application which states that such agency will direct a class of public utilities of which the taxpayer is a member to use a flow-through method of regulated accounting. The presumption described in this subdivision may be rebutted by evidence that the flow-through method of regulated accounting is being used by the taxpayer with respect to such property.

(iii) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Corporation X is a calendar-year taxpayer and its "applicable 1968 method" is a straight line method of depreciation. Effective January 1, 1970, X began collecting rates which were based on a sum of the years-digits method of depreciation and a normalization method of regulated accounting which rates had been approved by

a regulatory body having jurisdiction over X. On October 1, 1971, a court of proper jurisdiction annulled the rate order prospectively, which annulment was not appealed, on the basis that the regulatory body had abused its discretion by determining the rates on the basis of a normalization method of regulated accounting. As there was no inconsistent expression of intent during 1970 or prior to the due date of X's return for 1970, X's use of the sum of the years-digits method of depreciation for purposes of section 167 on such return was proper. For 1971, the presumption is in effect through September 30. During 1971, X may use the sum of the years-digits method of depreciation for purposes of section 167 from January 1 through September 30, 1971. After September 30, 1971, and for taxable years after 1971, X must use a straight line method of depreciation until the inconsistent court decision is no longer in effect.

Example (2). Assume the same facts as in example (1), except that pursuant to the order of annulment, X was required to refund the portion of the rates attributable to the use of the normalization method of regulated accounting. As there was no inconsistent expression of intent during 1970 or prior to the due date of X's return for 1970, X has the benefit of the presumption with respect to its use of the sum of the years-digits method of depreciation for purposes of section 167, but because of the retroactive nature of the rate order X must file an amended return for 1970 using a straight line method of depreciation. As the inconsistent decision by the court was handed down prior to the due date of X's Federal income tax return for 1971, for 1971 and thereafter the presumption of subdivision (ii) of this subparagraph does not apply. X must file its Federal income tax returns for such years using a straight line method of depreciation.

Example (3). Assume the same facts as in example (2), except that the annulment order was stayed pending appeal of the decision to a court of proper appellate jurisdiction, X has the benefit of the presumption as described in example (2) for the year 1970, but for 1971 and thereafter the presumption of subdivision (ii) of this subparagraph does not apply. Further, X must file an amended return for 1970 using a straight line method of depreciation and for 1971 and thereafter X must file its returns using a straight line method of depreciation unless X and the district director have consented in writing to extend the time for assessment of tax for 1970 and thereafter with respect to the issue of normalization method of regulated accounting for as long as may be necessary to allow for resolution of the appeal with respect to the annulment of the rate order.

(5) *Change in method of regulated accounting.* The taxpayer shall notify the district director of a change in its method of regulated accounting, an order by a regulatory body or court that such method be changed, or an interim or final rate determination by a regulatory body which determination is inconsistent with the method of regulated accounting used by the taxpayer immediately prior to the effective date of such rate determination. Such notification shall be made within 90 days of the date that the change in method, the order, or the determination is effective. In the case of a change in the method of regulated accounting, the taxpayer shall recompute its tax liability for any affected taxable year and such recomputation shall be made in the form of an amended return where necessary unless the taxpayer and the district director have consented in writing to extend the time for assessment of tax with respect to the issue of normalization method of regulated accounting.

(6) *Exclusion of normalization reserve from rate base.* (i) Notwithstanding the provisions of subparagraph (1) of this paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking.

(ii) For the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i) of this subparagraph, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for the period is the amount of the reserve (determined under subparagraph (2) of this paragraph) at the end of the historical period. If solely a future period is used

for such determination, the amount of the reserve account for the period is the amount of the reserve at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during such period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period. The pro rata portion of any increase to be credited or decrease to be charged during a future period (or the future portion of a part-historical and part-future period) shall be determined by multiplying any such increase or decrease by a fraction, the numerator of which is the number of days remaining in the period at the time such increase or decrease is to be accrued, and the denominator of which is the total number of days in the period (or future portion).

(iii) The provisions of subdivision (i) of this subparagraph shall not apply in the case of a final determination of a rate case entered on or before May 31, 1973. For this purpose, a determination is final if all rights to request a review, a rehearing, or a redetermination by the regulatory body which makes such determination have been exhausted or have lapsed. The provisions of subdivision (ii) of this subparagraph shall not apply in the case of a rate case filed prior to June 7, 1974 for which a rate order is entered by a regulatory body having jurisdiction to establish the rates of the taxpayer prior to September 5, 1974, whether or not such order is final, appealable, or subject to further review or reconsideration.

(iv) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Corporation X is exclusively engaged in the transportation of gas by pipeline subject to the jurisdiction of the Z Power Commission. With respect to its post-1969 public utility property, X is entitled under section 167(l)(2)(B) to use a method of depreciation other than a subsection (l) method if it uses a normalization method of regulated accounting. With respect to X the Z Power Commission for purposes of establishing cost of service uses a recent consecutive 12-month period ending not more than 4 months prior to the date of filing a rate case adjusted for certain known changes occurring within a 9-month period subsequent to the base period. X's rate case is filed on January 1, 1975. The year 1974 is the recorded test period for X's rate case and is the period used in determining X's tax expense in computing cost of service. The rates are contemplated to be in effect for the years 1975, 1976, and 1977. The adjustments for known changes relate only to wages and salaries. X's rate base at the end of 1974 is $145,000,000. The amount of the reserve for deferred taxes under section 167(l) at the end of 1974 is $1,300,000, and the reserve is projected to be $4,400,000 at the end of 1975, $6,500,000 at the end of 1976, and $9,800,000 at the end of 1977. X does not use a normalization method of regulated accounting if the Z Power Commission excludes more than $1,300,000 from the rate base to which X's rate of return is applied. Similarly, X does not use a normalization method of regulated accounting if, instead of the above, the Z Power Commission, in determining X's rate of return which is applied to the rate base, assigns to no-cost capital an amount that represents the reserve account for deferred tax that is greater than $1,300,000.

Example (2). Assume the same facts as in example (1) except that the adjustments for known changes in cost of service made by the Z Power Commission include an additional depreciation expense that reflects the installation of new equipment put into service on January 1, 1975. Assume further that the reserve for deferred taxes under section 167(l) at the end of 1974 is $1,300,000 and that the monthly net increases for the first 9 months of 1975 are projected to be:

January 1-31	$310,000
February 1-28	300,000
March 1-31	300,000
April 1-30	280,000
May 1-31	270,000
June 1-30	260,000
July 1-31	260,000
August 1-31	250,000
September 1-30	240,000
	$2,470,000

For its regulated books of account X accrues such increases as of the last day of the month but as a matter of convenience credits increases or charges decreases to the reserve account on the 15th day of the month following the whole month for which such

increase or decrease is accrued. The maximum amount that may be excluded from the rate base is $2,470,879 (the amount in the reserve at the end of the historical portion of the period ($1,300,000) and a pro rata portion of the amount of any projected increase for the future portion of the period to be credited to the reserve ($1,170,879)). Such pro rata portion is computed (without regard to the date such increase will actually be posted to the account) as follows:

$310,000 × 243/273 =	$275,934
300,000 × 215/273 =	236,264
300,000 × 184/273 =	202,198
280,000 × 154/273 =	157,949
270,000 × 123/273 =	121,648
260,000 × 93/273 =	88,571
260,000 × 62/273 =	59,048
250,000 × 31/273 =	28,388
240,000 × 1/273 =	879
	$1,170,879

Example (3). Assume the same facts as in example (1) except that for purposes of establishing cost of service the Z Power Commission uses a future test year (1975). The rates are contemplated to be in effect for 1975, 1976, and 1977. Assume further that plant additions, depreciation expense, and taxes are projected to the end of 1975 and that the reserve for deferred taxes under section 167(l) is $1,300,000 for 1974 and is projected to be $4,400,000 at the end of 1975. Assume also that the Z Power Commission applies the rate of return to X's 1974 rate base of $145,000,000. X and the Z Power Commission through negotiation arrive at the level of approved rates. X uses a normalization method of regulated accounting only if the settlement agreement, the rate order, or record of the proceedings of the Z Power Commission indicates that the Z Power Commission did not exclude an amount representing the reserve for deferred taxes from X's rate base ($145,000,000) greater than $1,300,000 plus a pro rata portion of the projected increases and decreases that are to be credited or charged to the reserve account for 1975. Assume that for 1975 quarterly net increases are projected to be:

1st quarter	$910,000
2nd quarter	810,000
3rd quarter	750,000
4th quarter	630,000
Total	$3,100,000

For its regulated books of account X will accrue such increases as of the last day of the quarter but as a matter of convenience will credit increases or charge decreases to the reserve account on the 15th day of the month following the last month of the quarter for which such increase or decrease will be accrued. The maximum amount that may be excluded from the rate base is $2,591,480 (the amount of the reserve at the beginning of the period ($1,300,000) plus a pro rata portion ($1,291,480) of the $3,100,000 projected increase to be credited to the reserve during the period). Such portion is computed (without regard to the date such increase will actually be posted to the account) as follows:

$910,000 × 276/365 =	$688,110
810,000 × 185/365 =	410,548
750,000 × 93/365 =	191,096
630,000 × 1/365 =	1,726
	$1,291,480

(i) *Flow-through method of regulated accounting.* Under section 167(l)(3)(H), a taxpayer uses a flow-through method of regulated accounting with respect to public utility property if it uses the same method of depreciation (other than a subsection (l) method) to compute its allowance for depreciation under section 167 and to compute its tax expense for purposes of reflecting operating results in its regulated books of account unless such method is the same method used by the taxpayer to determine its depreciation expense for purposes of reflecting operating results in its regulated books of account. Except as provided in the preceding sentence, the method of depreciation used by a taxpayer with respect to public utility property for purposes of determining cost of service for ratemaking purposes or rate base for ratemaking purposes shall not be considered in determining whether the taxpayer used a flow-through method of regulated accounting. A taxpayer may establish use of a flow-through method of regulated accounting in the same manner that compliance with normalization requirements in respect of operating books of account may be established under paragraph (h)(4) of this section.

[T.D. 7315, 39 FR 20195, June 7, 1974]

§ 1.167(l)–2 Public utility property; election as to post-1969 property representing growth in capacity.

(a) *In general.* Section 167(l)(2) prescribes the methods of depreciation which may be used by a taxpayer with respect to its post-1969 public utility property. Under section 167(l)(2) (A)

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and (B) the taxpayer may use a subsection (l) method of depreciation (as defined in section 167(l)(3)(F)) or any other method of depreciation which is otherwise allowable under section 167 if, in conjunction with the use of such other method, such taxpayer uses the normalization method of accounting (as defined in section 167(l)(3)(G)). Paragraph (2)(C) of section 167(l) permits a taxpayer which used the flow-through method of accounting for its July 1969 accounting period (as these terms are defined in section 167(l)(3)(H) and (I), respectively) to use its applicable 1968 method of depreciation with respect to certain property. Section 167(l)(3)(D) describes the term "applicable 1968 method". Accordingly, a regulatory agency is not precluded by section 167(l) from requiring such a taxpayer subject to its jurisdiction to continue to use the flow-through method of accounting unless the taxpayer makes the election pursuant to section 167(l)(4)(A) and this section. Whether or not the election is made, if such a regulatory agency permits the taxpayer to change from the flow-through method of accounting, subsection (l)(2) (A) or (B) would apply and such taxpayer could, subject to the provisions of section 167(e) and the regulations thereunder (relating to change in method), use a subsection (l) method of depreciation or, if the taxpayer uses the normalization method of accounting, any other method of depreciation otherwise allowable under section 167.

(1) *Election.* Under subparagraph (A) of section 167(l)(4), if the taxpayer so elects, the provisions of paragraph (2)(C) of section 167(l) shall not apply to its qualified public utility property (as such term is described in paragraph (b) of this section). In such case the taxpayer making the election shall use a method of depreciation prescribed by section 167(l)(2) (A) or (B) with respect to such property.

(2) *Property to which election shall apply.* (i) Except as provided in subdivision (ii) of this subparagraph the election provided by section 167(l)(4)(A) shall apply to all of the qualified public utility property of the taxpayer.

(ii) In the event that the taxpayer wishes the election provided by section 167(l)(4)(A) to apply to only a portion of its qualified public utility property, it must clearly identify the property to be subject to the election in the statement of election described in paragraph (e) of this section. Where all property which performs a certain function is included within the election, the election shall apply to all future acquisitions of qualified public utility property which perform the same function. Where only certain property within a functional group of property is included within the election, the election shall apply only to property which is of the same kind as the included property.

(iii) The provisions of subdivision (ii) of this subparagraph may be illustrated by the following examples:

Example (1). Corporation *A*, an electric utility company, wishes to have the election provided by section 167(l)(4)(A) apply only with respect to its production plant. A statement that the election shall apply only with respect to production plant will be sufficient to include within the election all of the taxpayer's qualified production plant of any kind. All public utility property of the taxpayer other than production plant will not be subject to the election.

Example (2). Corporation *B*, an electric utility company, wishes to have the election provided by section 167(l)(4)(A) apply only with respect to nuclear production plant. A statement which clearly indicates that only nuclear production plant will be included in the election will be sufficient to exclude from the election all public utility property other than nuclear production plant.

(b) *Qualified public utility property*—(1) *Definition.* For purposes of this section the term "qualified public utility property" means post-1969 public utility property to which section 167(l)(2)(C) applies, or would apply if the election described in section 167(l)(4)(A) had not been made, to the extent that such property constitutes property which increases the productive or operational capacity of the taxpayer with respect to the goods or services described in section 167(l)(3)(A) and does not represent the replacement of existing capacity. In the event that particular assets which are post-1969 public utility property both replace existing public utility

property and increase the productive or operational capacity of the taxpayer, only that portion of each such asset which is properly allocable, pursuant to the provisions of subparagraph (3)(v) of this paragraph or paragraph (c)(2) of this section (as the case may be), to increasing the productive or operational capacity of the taxpayer shall be qualified public utility property.

(2) *Limitation on use of formula method.* A taxpayer which makes the election with respect to all of its post-1969 public utility property may determine the amount of its qualified public utility property by using the formula method described in paragraph (c) of this section or, where the taxpayer so chooses, it may use any other method based on engineering data which is satisfactory to the Commissioner. A taxpayer which chooses to include only a portion of its post-1969 public utility property in the election described in paragraph (a)(1) of this section shall, in a manner satisfactory to the Commissioner and consistent with the provisions of subparagraph (3) of this paragraph, use a method based on engineering data. If a taxpayer uses the formula method described in paragraph (c) of this section, it must continue to use such method with respect to additions made in subsequent taxable years. The taxpayer may change from an engineering method to the formula method described in paragraph (c) of this section by filing a statement described in paragraph (h) of this section if it could have used such formula method for the prior taxable year.

(3) *Measuring capacity under an engineering method in the case of a general election.* (i) The provisions of this subparagraph apply in the case of an election made with respect to all of the post-1969 public utility property of the taxpayer.

(ii) A taxpayer which uses a method based on engineering data to determine the portion of its additions for a taxable year which constitutes qualified public utility property shall make such determination with reference to its "adjusted capacity" as of the first day of the taxable year during which such additions are placed in service. For purposes of this subparagraph, the term "adjusted capacity" means the taxpayer's capacity as of January 1, 1970, adjusted upward in the manner described in subdivision (iii) of this subparagraph for each taxable year ending after December 31, 1969, and before the first day of the taxable year during which the additions described in the preceding sentence are placed in service.

(iii) The adjustment described in this subdivision for each taxable year shall be equal to the number of units of capacity by which additions for the taxable year of public utility property with respect to which the election had been made exceed the number of units of capacity of retirements for such taxable year of public utility property with respect to which the flow-through method of accounting was being used at the time of their retirement. If for any taxable year the computation in the preceding sentence results in a negative amount, such negative amount shall be taken into account as a reduction in the amount of the adjustment (computed without regard to this sentence) in succeeding taxable years.

(iv) The provisions of this subparagraph may be illustrated by the following table which assumes that the taxpayer's adjusted capacity as of January 1, 1970, was 5,000 units:

1	2	3	4	5	6	7
Year	Additions	Flow-through retirements	Net additions	Adjusted capacity [1]	Actual capacity	Units of qualified additions [1] [2]
1970	1000	700	300	5000	5300	300
1971	300	500	(200)	5300	5100	
1972	500	200	300	5300	5400	100
1973	400	800	(400)	5400	5000	
1974	600	400	200	5400	5200	
1975	800	300	500	5400	5700	300

[1] Capacity as of Jan. 1, 1970, plus amounts in column 7 for years prior to the year for which determination is being made.
[2] Column 6 minus column 5.

(v) The qualified portion of the basis for depreciation (as defined in section 167(g)) of each asset or group of assets (if group or composite accounting is used by the taxpayer) subject to the election shall be determined using the following ratio:

Qualified portion of basis of asset ÷ Total basis of asset = Units of qualified additions computed in column 7 on chart ÷ Units of capacity of additions computed in column 2 on chart.

(c) *Formula method of determining amount of property subject to election*—(1) *In general.* The following formula method may be used to determine the amount of qualified public utility property:

Step 1. Find the total cost (within the meaning of section 1012) to the taxpayer of additions during the taxable year of all post-1969 public utility property with respect to which section 167(l)(2)(C) would apply if the election had not been made.

Step 2. Aggregate the cost (within the meaning of section 1012) to the taxpayer of all retirements during the taxable year of public utility property with respect to which the flow-through method of accounting was being used at the time of their retirement.

Step 3. Subtract the figure reached in step 2 from the figure reached in step 1.

In the event that the figure reached in step 2 exceeds the figure reached in step 1 such excess shall be carried forward to the next taxable year and shall be aggregated with the cost (within the meaning of section 1012) to the taxpayer of all retirements referred to in step 2 for such next taxable year.

(2) *Allocation of bases.* The amount of qualified public utility property as determined in accordance with the formula method described in subparagraph (1) of this paragraph shall be allocated to the basis for depreciation (as defined in section 167(g)) of each asset or group of assets (if group or composite accounting is used by the taxpayer) subject to the election using the following ratio:

Amount of qualified additions computed in step 3 ÷ Amount of total additions computed in step 1 = Qualified portion of basis of asset ÷ Total basis of asset.

(d) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). Corporation *A*, a telephone company subject to the jurisdiction of the Federal Communications Commission, elected, pursuant to the provisions of section 167(l)(4)(A) and this section, with respect to all of its qualified post-1969 public utility property to have the provisions of paragraph (2) (C) of section 167(l) not apply. In 1971 the Corporation added new underground cable with a cost (within the meaning of section 1012) to it of $4 million to its underground cable account. In the same year it retired public utility property with a cost (within the meaning of section 1012) to Corporation *A* of $1.5 million. The flow-through method of accounting was being used with respect to all of the retired property at the time of retirement. Using the formula method described in paragraph (c) of this section, the amount of qualified underground cable would be determined as follows:

	Million
Step 1. Aggregate cost of flow-through additions	$4.0
Step 2. Cost of all flow-through retirements	1.5
Step 3. Figure reached in step 1 less figure reached in step 2	2.5

The amount of qualified public utility property to which section 167(l)(2)(C) will not apply is $2.5 million. Pursuant to the provisions of paragraph (c)(2) of this section, the amount of qualified public utility property would be allocated to the basis for depreciation (as defined in section 167(g)) of an asset with a total basis for depreciation of $2 million as follows:

$2.5 million (figure in step 3)/$4 million (figure in step 1) = Qualified portion of basis of asset/$2 million Qualified portion of basis of asset = $1.25 million.

Example (2). In 1972 Corporation *A* (the corporation described in example (1)) added underground cable with a cost (within the meaning of section 1012) to it of $1 million. In the same year the cost (within the meaning of section 1012) to the corporation of retirements of public utility property with respect to which the flow-through method of accounting was being used was $3 million. There were no other additions or retire-

ments. The amount of qualified public utility property would be determined as follows:

	Million
Step 1. Aggregate cost of flow-through additions	$1.0
Step 2. Cost of all flow-through retirements	3.0
Step 3. Figure reached in step 1 less figure reached in step 2	(2.0)

Since retirements of flow-through public utility property for the year 1972 exceeded additions made during such year, the excess retirements, $2.0 million, must be carried forward to be aggregated with retirements for 1973.

Example (3). Corporation *B*, a gas pipeline company subject to the jurisdiction of the Federal Power Commission, made the election provided by section 167(l)(4)(A) and this section with respect to all of its post-1969 public utility property. Corporation *B* chose to use an engineering data method of determining which property was subject to the election provided by this section. In 1970, the corporation replaced a portion of its pipeline with respect to which the flow-through method of accounting was being used at the time of its retirement which had a peak capacity on January 1, 1970, of 100,000 thousand cubic feet (M c.f.) per day at a pressure of 14.73 pounds per square inch absolute (p.s.i.a.) with pipe with a capacity of 125,000 M c.f. per day at 14.73 p.s.i.a. Assuming that there were no other additions or retirements, using an engineering data method one-fifth of the new pipeline would be property subject to the election of this section effective for its taxable year beginning on January 1, 1971.

Example (4). In 1970 Corporation *C* (with the same characteristics as the corporation described in example (3)) extended its pipeline 5 miles further than it extended on January 1, 1970. Assuming that there were no other additions or retirements, the entire extension would be property subject to the election provided by this section effective for its taxable year beginning on January 1, 1971.

Example (5). As a result of a change of service areas between two corporations, in 1970 Corporation *D* (with the same characteristics as the corporation described in example (3)) retired a pipeline running north and south and replaced it with a pipeline of equal length and capacity running east and west. No part of the pipeline running east and west is property subject to the election.

(e) *Manner of making election.* The election described in paragraph (a) of this section shall be made by filing, in duplicate, with the Commissioner of Internal Revenue, Washington, D.C. 20224, Attention, T:I:E, a statement of such election.

(f) *Content of statement.* The statement described in paragraph (e) of this section shall indicate that an election is being made under section 167(l) of the Internal Revenue Code of 1954, and it shall contain the following information:

(1) The name, address, and taxpayer identification number of the taxpayer,

(2) Whether the taxpayer will use the formula method of determining the amount of its qualified public utility property described in paragraph (c) of this section, or an engineering method, and

(3) Where the taxpayer wishes to include only a portion of its public utility property in the election pursuant to the provisions of paragraph (a) (2) of this section, a description sufficient to clearly identify the property to be included.

(g) *Time for making election.* The election permitted by this section shall be made by filing the statement described in paragraph (e) of this section not later than Monday, June 29, 1970.

(h) *Change of method of determining amount of qualified property.* Where a taxpayer which has elected pursuant to the provisions of section 167(l)(4)(A) wishes to change, pursuant to the provisions of paragraph (b)(2) of this section, from an engineering data method of determining which of its property is qualified public utility property to the formula method described in paragraph (c) of this section, it may do so by filing a statement to that effect at the time that it files its income tax return, with the district director or director of the regional service center, with whom the taxpayer's income tax return is required to be filed.

(i) *Revocability of election.* An election made under section 167(l) shall be irrevocable.

(j) *Effective date.* The election prescribed by section 167(l)(4)(A) and this section shall be effective for taxable years beginning after December 31, 1970.

[T.D. 7045, 35 FR 8933, June 10, 1970. Redesignated by T.D. 7315, 39 FR 20195, June 7, 1974]

§ 1.167(l)-3 Multiple regulation, asset acquisitions, reorganizations, etc.

(a) *Property not entirely subject to jurisdiction of one regulatory body*—(1) *In general.* If a taxpayer which uses a method of depreciation other than a subsection (l) method of depreciation is required by a regulatory body having jurisdiction over less than all of its property to use, or not to use, a method of regulated accounting (i.e., normalization or flow-through), such taxpayer shall be considered as using, or not using, such method of regulated accounting only with respect to property subject to the jurisdiction of such regulatory body. In the case of property which is contained in a multiple asset account, the provisions of § 1.167(a)-7(c) and § 1.167(a)-11(c)(1)(iv) apply to prohibit depreciating a single account by two or more different methods.

(2) *Jurisdiction of regulatory body.* For purposes of this paragraph, a regulatory body is considered to have jurisdiction over property of a taxpayer if expenses with respect to the property are included in cost of service as determined by the regulatory body for ratemaking purposes or for reflecting operating results in its regulated books of account. For example, if regulatory body A, having jurisdiction over 60 percent of an item of X corporation's public utility property, required X to use the flow-through method of regulated accounting in circumstances which would bar X from using a method of depreciation under section 167(a) other than a subsection (l) method, and if regulatory body B, having jurisdiction over the remaining 40 percent of such item of property does not so require X to use the flow-through method of regulated accounting (or if the remaining 40 percent is not subject to the jurisdiction of any regulatory body), then with respect to 60 percent of the adjusted basis of the property X is prohibited from using a method of depreciation for purposes of section 167(a) other than a subsection (1) method. If in such example, A, having jurisdiction over 60 percent of X's public utility property, had jurisdiction over 100 percent of a particular generator, then with respect to the generator X would be prohibited from using a method of depreciation other than a subsection (l) method.

(3) *Public utility property subject to more than one regulatory body.* If a regulatory body having jurisdiction over public utility property with respect to the taxpayer's regulated books of account requires the taxpayer to reflect its tax expense in such books in the manner used by the regulatory body having jurisdiction over the public utility property for purposes of determining the taxpayer's cost of service for ratemaking purposes, the rules of subparagraphs (1) and (2) of this paragraph shall apply.

(b) *Leasing transactions*—(1) *Leased property.* Public utility property as defined in paragraph (b) of § 1.167(l)-1 includes property which is leased by a taxpayer where the leasing of such property is part of the lessor's section 167(l) public utility activity. Thus, such leased property qualifies as public utility property even though the predominant use of such property by the lessee is in other than a section 167(l) public utility activity. Further, leased property qualifies as public utility property under section 167(l) even though the leasing is not part of the lessor's public utility activity if the predominant use of such property by the lessee or any sublessee is in a section 167(l) public utility activity. However, the limitations of section 167(l) apply to a taxpayer only if such taxpayer is subject to the jurisdiction of a regulatory body described in a section 167(l)(3)(A). For example, if a financial institution purchases property which it then leases to a lessee which uses such property predominantly in a section 167(l) public utility activity, the property qualifies as public utility property. However, because the financial institution's rates for leasing the property are not subject to the jurisdiction of a regulatory body described in section 167(l)(3)(A), the provisions of section 167(l) do not apply to the depreciation deductions taken with respect to the property by the financial institution. For possible application of section 167(l) to the lessee, see subparagraph (2) of this paragraph.

(2) *Certain rental payments.* Under section 167(l)(5), if a taxpayer leases property which is public utility prop-

erty and the regulatory body having jurisdiction over such property for purposes of determining the taxpayer's operating results in its regulated books of account or for ratemaking purposes allows only an amount of such lessee's expenses with respect to the lease which is less than the amount which the taxpayer deducts for purposes of its Federal income tax liability, then a portion of the difference between such amounts shall not be allowed as a deduction by the taxpayer for purposes of its Federal income tax liability in such manner and time as the Commissioner or his delegate may determine consistent with the principles of § 1.167(l)–1 and this section applicable as to when a method of depreciation other than a subsection (1) method may be used for purposes of section 167(a).

(c) *Certain partnership arrangements.* Under section 167(l)(5), if property held by a partnership is not public utility property in the hands of the partnership but would be public utility property if an election was made under section 761 to be excluded from partnership treatment, then section 167(l) shall be applied by treating the partners as directly owning the property in proportion to their partnership interests.

(d) *Cross reference.* See § 1.167(l)–1(c)(1) for treatment of certain property as "pre-1970 public utility property" and § 1.167(l)–1(e)(4)(ii) for applicable 1968 method in the case of property acquired in certain transactions.

[T.D. 7315, 39 FR 20202, June 7, 1974]

§ 1.167(l)–4 Public utility property; election to use asset depreciation range system.

(a) *Application of section 167(l) to certain property subject to asset depreciation range system.* If the taxpayer elects to compute depreciation under the asset depreciation range system described in § 1.167(a)–11 with respect to certain public utility property placed in service after December 31, 1970, see § 1.167(a)–11(b)(6).

(Sec. 167 of the Internal Revenue Code of 1954 (26 U.S.C. 167) and sec. 7805 of the Internal Revenue Code of 1954 (26 U.S.C. 7805))

[T.D. 7128, 36 FR 11939, June 23, 1971. Redesignated by T.D. 7315, 39 FR 20203, June 7, 1974]

§ 1.167(m)–1 Class lives.

(a) For rules regarding the election to use the class life system authorized by section 167(m), see the provisions of § 1.167(a)–11.

(Sec. 167(m), 85 Stat. 508 (26 U.S.C. 167))

[T.D. 7272, 38 FR 9986, Apr. 23, 1973]

§ 1.168–1 Amortization of emergency facilities; general rule.

(a) A person (including an estate or trust (see section 642(f) and § 1.642(f)–1) and a partnership (see section 703 and § 1.703–1)) is entitled, by election, to a deduction with respect to the amortization of the adjusted basis (for determining gain) of an emergency facility, such amortization to be based on a period of 60 months. As to the adjusted basis of an emergency facility, see § 1.168–5. The taxpayer may elect to begin the 60-month amortization period with (1) the month following the month in which such facility was completed or acquired, or (2) the taxable year succeeding that in which such facility was completed or acquired (see § 1.168–2). The date on which, or the month within which, an emergency facility is completed or acquired is to be determined upon the facts in the particular case. Ordinarily, the taxpayer is in possession of all the facts and, therefore, in a position to ascertain such date. A statement of the date ascertained by the taxpayer, together with a statement of the pertinent facts relied upon, should be filed with the taxpayer's election to take amortization deductions with respect to such facility.

(b) Generally, an amortization deduction will not be allowed with respect to an emergency facility for any taxable year unless such facility has been certified before the date of filing of the taxpayer's income tax return for such taxable year. However, this limitation does not apply in the case of a certificate made after August 22, 1957, for an emergency facility to provide primary processing for uranium ore or uranium concentrate under a program of the Atomic Energy Com-

mission for the development of any sources of uranium ore or uranium concentrate, if application for such certificate was filed either (1) before September 2, 1958, and before the expiration of six months after the beginning of construction, reconstruction, erection, or installation or the date of acquisition of the facility, or (2) after September 1, 1958, and on or before December 2, 1958.

(c) In general, with respect to each month of the 60-month period which falls within the taxable year, the amortization deduction is an amount equal to the adjusted basis of the facility at the end of each month divided by the number of months (including the particular month for which the deduction is computed) remaining in the 60-month period. The adjusted basis at the end of any month shall be computed without regard to the amortization deduction for such month. The total amortization deduction with respect to an emergency facility for a particular taxable year is the sum of the amortization deductions allowable for each month of the 60-month period which falls within such taxable year. The amortization deduction taken for any month is in lieu of the deduction for depreciation which would otherwise be allowable under section 167. See, however, § 1.168-6, relating to depreciation with respect to any portion of the emergency facility not subject to amortization.

(d) This section may be illustrated by the following examples:

Example (1). On July 1, 1954, the X Corporation, which makes its income tax returns on the calendar year basis, begins the construction of an emergency facility which is completed on September 30, 1954, at a cost of $240,000. The certificate covers the entire construction. The X Corporation elects to take amortization deductions with respect to the facility and to begin the 60-month amortization period with October, the month following its completion. The adjusted basis of the facility at the end of October is $240,000. The allowable amortization deduction with respect to such facility for the taxable year 1954 is $12,000, computed as follows:

Monthly amortization deductions:	
October: $240,000 divided by 60	$4,000
November: $236,000 ($240,000 minus $4,000) divided by 59	4,000
December: $232,000 ($236,000 minus $4,000) divided by 58	4,000
Total amortization deduction for 1954	12,000

Example (2). The Y Corporation, which makes its income tax returns on the basis of a fiscal year ending November 30, purchases an emergency facility (No. 1) on July 29, 1955. On June 15, 1955, it begins the construction of an emergency facility (No. 2) which is completed on August 2, 1955. The entire acquisition and construction of such facilities are covered by the certificate. The Y Corporation elects to take amortization deductions with respect to both facilities and to begin the 60-month amortization period in each case with the month following the month of acquisition or completion. At the end of the first month of the amortization period the adjusted basis of facility No. 1 is $300,000 and the adjusted basis of facility No. 2 is $54,000. In September 1955, facility No. 1 is damaged by fire, as a result of which its adjusted basis is properly reduced by $25,370. The allowable amortization deduction with respect to such facilities for the taxable year ending November 30, 1955, is $21,410, computed as follows:

Facility No. 1

Monthly amortization deductions:	
August: $300,000 divided by 60	$5,000
September: $269,630 ($300,000 minus $5,000 and $25,370) divided by 59	4,570
October: $265,060 ($269,630 minus $4,570) divided by 58	4,570
November: $260,490 ($265,060 minus $4,570) divided by 57	4,570
Amortization deduction for 1955	18,710

Facility No. 2

Monthly amortization deductions:	
September: $54,000 divided by 60	$900
October: $53,100 divided by 59	900
November: $52,200 divided by 58	900
Amortization deduction for 1955	2,700
Total amortization deduction for 1955	21,410

Example (3). On June 15, 1954, the Z Corporation, which makes its income tax returns on the calendar year basis, completes the construction of an emergency facility at a cost of $110,000. In its income tax return for 1954, filed on March 15, 1955, the Z Corporation elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with July 1954, the month following its completion. No certificate with respect to such facility is made until April 10, 1955,

and therefore no amortization deduction with respect to such facility is allowable for any month in the taxable year 1954. The Z Corporation is entitled, however, to take a deduction for depreciation of such facility for the taxable year 1954, such deduction being assumed, for the purposes of this example, to be $2,000. Accordingly, the adjusted basis of such facility at the end of January 1955 (without regard to the amortization deduction for such month) is $108,000 ($110,000 minus $2,000). For the taxable year 1955, the Z Corporation is, with respect to such facility, entitled to an amortization deduction of $24,000, computed as follows:

Monthly amortization deductions:	
January: $108,000 divided by 54	$2,000
February: $106,000 ($108,000 minus $2,000) divided by 53	2,000
March: $104,000 ($106,000 minus $2,000) divided by 52	2,000
For the remaining nine months (similarly computed)	18,000
Total amortization deduction for 1955	24,000

Since the Z Corporation elected in its return for 1954 to take amortization deductions with respect to such facility and to begin the 60-month amortization period with July 1954, it must compute its amortization deductions for the 12 months in the taxable year 1955 on the basis of the remaining months of the established 60-month amortization period, as indicated in the above computation.

§ 1.168–2 Election of amortization.

(a) *General rule.* An election by the taxpayer to take amortization deductions with respect to an emergency facility and to begin the 60-month amortization period either with the month following the month in which such facility was completed or acquired, or with the taxable year succeeding the taxable year in which such facility was completed or acquired, shall be made by a statement to that effect in its return for the taxable year in which falls the first month of the 60-month amortization period so elected. However, if the facility is described in section 168(e)(2)(C) and an application for a certificate is filed within the period prescribed by section 9(c) of the Technical Amendments Act of 1958 (72 Stat. 1609) and paragraph (b) of § 1.168–1, the election may be made by a statement in an amended income tax return for the taxable year in which falls the first month of the 60-month amortization period so elected. The statement and amended return in such case must be filed not later than 90 days after the date the certificate is made or not later than April 4, 1960, whichever is later. Amended income tax returns or claims for credit or refund should also be filed for other taxable years which are within such amortization period and which precede the taxable year in which the election is made. Nothing in this paragraph should be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(b) *Election not made, in prescribed manner.* If the statement of election is not made by the taxpayer as prescribed in paragraph (a) of this section, it may, in the discretion of the Commissioner and for good cause shown, be made in such manner and form and within such time as may be approved by the Commissioner.

(c) *Other requirements and considerations.* No method of making such election other than those prescribed in this section and corresponding sections of prior regulations is permitted. Any statement of election should contain a description clearly identifying each emergency facility for which an amortization deduction is claimed. A taxpayer which does not elect, in the manner prescribed in this section or corresponding sections of prior regulations, to take amortization deductions with respect to an emergency facility shall not be entitled to such deductions.

§ 1.168–3 Election to discontinue amortization.

(a) If a taxpayer has elected to take amortization deductions with respect to an emergency facility, it may, after such election and prior to the expiration of the 60-month amortization period, discontinue the amortization deductions for the remainder of the 60-month period. An election to discontinue the amortization deductions shall be made by a notice in writing filed with the district director for the internal revenue district in which the return of the taxpayer is required to be filed, specifying the month as of the beginning of which the taxpayer

elects to discontinue such deductions. Such notice shall be filed before the beginning of the month specified therein, and shall contain a description clearly identifying the emergency facility with respect to which the taxpayer elects to discontinue the amortization deductions. If the taxpayer so elects to discontinue the amortization deductions, it shall not be entitled to any further amortization deductions with respect to such facility.

(b) A taxpayer which thus elects to discontinue amortization deductions with respect to an emergency facility is entitled, if such facility is depreciable property under section 167 and the regulations thereunder, to a deduction for depreciation with respect to such facility. The deduction for depreciation shall begin with the first month as to which the amortization deduction is not applicable, and shall be computed on the adjusted basis of the property as of the beginning of such month (see section 1011 and the regulations thereunder).

(c) This section may be illustrated by the following example:

Example. On July 1, 1954, the X Corporation, which makes its income tax returns on the calendar year basis, purchases an emergency facility, consisting of land with a building thereon, at a cost of $306,000 of which $60,000 is allocable to the land and $246,000 to the building. The certificate covers the entire acquisition. The corporation elects to take amortization deductions with respect to the facility and to begin the 60-month amortization period with the taxable year 1955. Depreciation of the building in the amount of $6,000 is deducted and allowed for the taxable year 1954. On March 25, 1956, the corporation files notice with the district director of its election to discontinue the amortization deductions beginning with the month of April 1956. The adjusted basis of the facility on January 31, 1955, is $300,000, or the cost of the facility ($306,000) less the depreciation allowed for 1954 ($6,000). The amortization deductions for the taxable year 1955 and the months of January, February, and March 1956, amount to $75,000, or $5,000 per month for 15 months. Since, at the beginning of the amortization period (January 1, 1955), the adjusted basis of the land ($60,000) is one-fifth of the adjusted basis of the entire facility ($300,000) and since there are no adjustments to basis other than on account of amortization during the period, the adjusted basis of the land should be reduced by $15,000, or one-fifth of the entire amortization deduction, and the adjusted basis of the building should be reduced by $60,000, or four-fifths of the entire amortization deduction. Accordingly, the adjusted basis of the facility as of April 1, 1956, is $225,000, of which $180,000 is allocable to the building for the purpose of depreciation deductions under section 167, and $45,000 is allocable to the land.

§ 1.168–4 Definitions.

As used in the regulations under section 168, the term—

(a) "Certifying authority" means the certifying authority designated by the President by Executive order.

(b) "Emergency facility" means any facility, land, building, machinery, or equipment, or any part thereof, the acquisition of which occurred after December 31, 1949, or the construction, reconstruction, erection, or installation of which was completed after such date, and with respect to which a certificate under section 168(e) has been made. In the case of an application for a certificate under section 168(e) which is filed after March 23, 1951, only the part of any such facility which is constructed, reconstructed, erected, or installed by any person not earlier than six months prior to the filing of such application, and which is certified in accordance with section 168(e), shall be deemed to be an emergency facility, notwithstanding that the other part of such facility was constructed, reconstructed, erected, or installed earlier than six months prior to the filing of such application. However, if the facility is one described in section 168(e)(2)(C) and the application was filed after September 1, 1958, and on or before December 2, 1958, the preceding sentence shall not apply. The term "emergency facility," as so defined, may include, among other things, improvements of land, such as the construction of roads, bridges, and airstrips, and the dredging of channels.

(c) "Emergency period" means the period beginning on January 1, 1950, and ending on the date on which the President proclaims that the utilization of a substantial portion of the certified emergency facilities is no

longer required in the interest of national defense.

§ 1.168–5 Adjusted basis of emergency facility.

(a) *In general.* (1) The adjusted basis of an emergency facility for the purpose of computing the amortization deduction may differ from what would otherwise constitute the adjusted basis of such emergency facility in that it shall be the adjusted basis for determining gain (see part II (section 1011 and following), subchapter 0, chapter 1 of the Code) and in that it may be only a portion of what would otherwise constitute the adjusted basis. It will be only a portion of such other adjusted basis if only a portion of the basis (unadjusted) is attributable to certified construction, reconstruction, erection, installation, or acquisition taking place after December 31, 1949. Also, it will be only a portion of what would otherwise constitute the adjusted basis of the emergency facility if only a portion of the basis (unadjusted) is certified as attributable to defense purposes or, in the case of a certification after August 22, 1957, if only a portion of the basis (unadjusted) is certified as attributable to the national defense program. It is therefore necessary first to determine the unadjusted basis of the emergency facility from which the adjusted basis for amortization purposes is derived.

(2) The unadjusted basis for amortization purposes is the same as the unadjusted basis otherwise determined only when the entire construction, reconstruction, erection, installation, or acquisition takes place after December 31, 1949, and is certified in its entirety by the certifying authority.

(3) In cases in which only a portion of the construction, reconstruction, erection, installation, or acquisition takes place after December 31, 1949, and that portion is certified in its entirety by the certifying authority, the unadjusted basis for the purpose of amortization is so much of the entire unadjusted basis as is attributable to the certified construction, reconstruction, erection, installation, or acquisition which takes place after December 31, 1949. For example, the X Corporation begins the construction of a facility on November 15, 1949, and such facility is completed on April 1, 1952, at a cost of $5,000,000, of which $4,600,000 is attributable to construction after December 31, 1949. The entire construction after December 31, 1949, is certified by the certifying authority. The unadjusted basis of the emergency facility for amortization purposes is therefore $4,600,000. For depreciation of the remaining portion ($400,000) of the cost see § 1.168–6.

(4) If the certifying authority certifies only a portion of the construction, reconstruction, erection, installation, or acquisition of property which takes place after December 31, 1949, the unadjusted basis for amortization purposes is limited to such portion so certified. Assuming the same facts as in the example in subparagraph (3) of this paragraph, except that only 50 percent of the construction, reconstruction, erection, installation, or acquisition after December 31, 1949, is certified, the unadjusted basis for amortization purposes is 50 percent of $4,600,000, or $2,300,000.

(5) The adjusted basis of an emergency facility for amortization purposes is the unadjusted basis for amortization purposes less the adjustments properly applicable thereto. Such adjustments are those specified in sections 1016 and 1017, except that no adjustments are to be taken into account which increase the adjusted basis. (See paragraph (b) of this section.) If the taxpayer constructs, reconstructs, erects, installs, or acquires an emergency facility pursuant to a cost reimbursement contract with an obligation for reimbursement by the United States of all or a part of the cost of such facility, the unadjusted basis of such facility for amortization purposes shall not include that part of the cost for which the taxpayer is entitled to reimbursement, and the amount received as reimbursement shall be treated as a capital receipt. However, amounts received by a taxpayer which represent in fact compensation by reason of termination of a government contract or payment for articles under such a contract, though denominated reimbursements for all or a part of the cost of an emergency facility, are not to be treated as capital receipts but

are to be taken into account in computing income, and are therefore not to be applied in reduction of the basis of such facility.

(6) The following examples will illustrate the computation of the adjusted basis of an emergency facility for amortization purposes:

Example (1). The X Corporation completes an emergency facility on July 1, 1954, the entire unadjusted basis of which is $500,000, and the unadjusted basis of which for the purpose of amortization is $300,000. The X Corporation elects to begin amortization as of January 1, 1955. The only adjustment to basis for the period July 1, 1954, to January 31, 1955, other than depreciation or amortization for January 1955, is $5,000 for depreciation for the last six months of 1954. The adjusted basis for the purpose of amortization is therefore $300,000 less $3,000 (300,000/500,000×$5,000), or $297,000.

Example (2). On July 31, 1956, the Y Corporation has an emergency facility (a building) which was completed on July 1, 1952, the entire basis of which is $500,000 and the unadjusted basis of which for the purpose of amortization is $300,000. The corporation elected to begin amortization as of January 1, 1953, at which time it was entitled to $5,000 depreciation for the last six months of 1952. On July 1, 1956, the facility was damaged by fire, as the result of which its adjusted basis is properly reduced by $200,000. The adjusted basis of the emergency facility as of July 1956 for the purpose of amortization and depreciation, and the adjusted basis for other purposes, are $23,849.18, $49,250.82, and $73,100.00, respectively, computed as follows:

	For amortization	For depreciation	For other purposes
Unadjusted basis	$300,000.00	$200,000.00	$500,000
Less depreciation to Jan. 1, 1953	3,000.00	2,000.00	5,000
Adjusted basis January 1953	297,000.00	198,000.00	495,000
Less amortization for 42 months	207,900.00		207,900
Less depreciation for 42 months		14,000.00	14,000
Adjusted basis at time of fire	89,100.00	184,000.00	273,100
Less fire loss (apportioned as explained below)	65,250.82	134,749.18	200,000
Adjusted basis after fire loss	23,849.18	49,250.82	73,100

The $200,000 fire loss is applied against the adjusted basis for the purpose of amortization and the adjusted basis for the purpose of depreciation in the proportion that each such adjusted basis at the time of the fire bears to their sum, i.e., 89,100/273,100×$200,000 or $65,250.82, against the amortization basis, and 184,000/273,100×$200,000, or $134,749.18 against the depreciation basis.

(b) *Capital additions.* (1) If, after the completion or acquisition of an emergency facility which has been certified by the certifying authority, further expenditures are made for construction, reconstruction, erection, installation, or acquisition attributable to such facility but not covered by such certification, such expenditures shall not be added to the adjusted basis of the emergency facility for amortization purposes under such certification. If such further expenditures are separately certified in accordance with the provisions of section 168(e)(1) or (2) and this section, they are treated as certified expenditures in connection with a new and separate emergency facility and, if proper election is made, will be taken into account in computing the adjusted basis of such new and separate emergency facility for the purpose of amortization.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. On March 1, 1954, the certifying authority certifies as an emergency facility a heating plant proposed to be constructed by the Z Corporation. Such facility is completed on July 1, 1954. The Z Corporation, on August 1, 1954, begins the installation in the plant of an additional boiler, which is not included in the certification for the plant but is certified as a new and separate emergency facility. For amortization purposes, the adjusted basis of the heating plant is determined without including the cost of the additional boiler. Such cost is taken into account in computing the adjusted basis of the new and separate emergency facility (the boiler), as to which the taxpayer has a separate election for amortization

purposes and a separate amortization period.

§ 1.168–6 Depreciation of portion of emergency facility not subject to amortization.

(a) The rule that an amortization deduction with respect to an emergency facility is in lieu of any deduction for depreciation which would otherwise be allowable under section 167 is subject to the exception provided in section 168(f). Under this exception, if the property constituting such facility is depreciable property under section 167 and the regulations thereunder and if the adjusted basis of such facility as computed under section 1011 for purposes other than the amortization deductions is in excess of the adjusted basis computed for the purpose of the amortization deductions, then the excess shall be charged off over the useful life of the facility and recovered through depreciation deductions. Thus, if the construction of an emergency facility is begun on or before December 31, 1949, and completed after such date, no amortization deductions are allowable with respect to the amount attributable to such construction on or before such date (see § 1.168–5). However, if the property constituting such facility is depreciable property under section 167 and the regulations thereunder, then the depreciation deduction provided by such section and regulations is allowable with respect to the amount attributable to such construction on or before December 31, 1949.

(b) Similarly, if only a portion of the construction, reconstruction, erection, installation, or acquisition after December 31, 1949, of an emergency facility has been certified by the certifying authority, and if such facility is depreciable property under section 167 and the regulations thereunder, then the depreciation deduction provided by such section and regulations is allowable with respect to the portion which has not been so certified.

(c) For illustration of the treatment of a depreciable portion of an emergency facility, see example (2) in paragraph (a)(6) of § 1.168–5.

§ 1.168–7 Payment by United States of unamortized cost of facility.

(a) Section 168(g) contemplates that certain payments may be made by the United States to a taxpayer as compensation for the unamortized cost of an emergency facility. If any such payment is properly includible in gross income and has been certified, as provided in section 168(g), as having been paid under the circumstances described therein, a taxpayer which is recovering the adjusted basis of an emergency facility through amortization rather than depreciation may elect to take an amount equal to such payment as an amortization deduction with respect to such facility for the month in which such payment is so includible. Such amortization deduction shall be in lieu of the amortization deduction otherwise allowable with respect to such facility for such month, but it shall not in any case exceed the adjusted basis of such facility (see § 1.168–5) as of the end of such month (computed without regard to any amortization deduction for such month). The election referred to in this paragraph shall be made in the return for the taxable year in which the amount of such payment is includible in gross income.

(b) If a taxpayer is recovering the adjusted basis of an emergency facility through depreciation rather than amortization, the depreciation deduction allowable under section 167 for the month in which the amount of any such payment is includible in gross income shall, at the taxpayer's election, be increased by such amount; but the total deduction with respect to the certified portion of such facility shall not in any case exceed the adjusted basis of such facility (computed as provided in section 168(e) and § 1.168–5 for amortization purposes) as of the end of such month (computed without regard to any amount allowable for such month under section 167 or 168(g)(2)). The election referred to in this paragraph shall be made in the return for the taxable year in which the amount of such payment is includible in gross income.

(c) This section may be illustrated by the following examples:

Example (1). On January 31, 1954, the X Corporation purchases an emergency facility at a cost of $600,000. The certificate covers the entire acquisition. The X Corporation elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with February 1954, the month following the month of acquisition. On July 15, 1955, as a result of the cancellation of certain contracts with the X Corporation, the United States makes a payment of $300,000 to the corporation as compensation for the unamortized cost of such facility. The $300,000 payment is includible in the X Corporation's gross income for July 1955. The adjusted basis of such facility for amortization purposes as of the end of July 1955, computed without regard to any amortization deduction for such month, is $430,000. Accordingly, the corporation is entitled to take an amortization deduction of $300,000 for such month, in lieu of the $10,000 amortization deduction which is otherwise allowable.

Example (2). On November 30, 1954, the Y Corporation purchases an emergency facility, consisting of land with a building thereon, at a cost of $500,000, of which $200,000 is allocable to the land and $300,000 to the building. The certificate covers the entire acquisition. The Y Corporation does not elect to take amortization deductions with respect to such facility, but is entitled to a depreciation deduction with respect to the building at the rate of 3 percent per annum, or $750 per month. On August 12, 1956, as a result of cancellation of certain contracts, the United States makes a payment of $400,000 to the corporation as compensation for the unrecovered cost of such facility. The $400,000 is includible in the Y Corporation's gross income for August 1956. The adjusted basis of the facility as of the end of August 1956, computed without regard to depreciation for such month, is $485,000, of which amount $200,000 is allocable to the land and $285,000 to the building. Accordingly, the corporation is entitled to increase the $750 depreciation deduction for August 1956 by the full amount of the $400,000 payment.

§ 1.169-1 Amortization of pollution control facilities.

(a) *Allowance of deduction*—(1) *In general.* Under section 169(a), every person, at his election, shall be entitled to a deduction with respect to the amortization of the amortizable basis (as defined in § 1.169-3) of any certified pollution control facility (as defined in § 1.169-2), based on a period of 60 months. Under section 169(b) and paragraph (a) of § 1.169-4, the taxpayer may further elect to begin such 60-month period either with the month following the month in which the facility is completed or acquired or with the first month of the taxable year succeeding the taxable year in which such facility is completed or acquired. Under section 169(c), a taxpayer who has elected under section 169(b) to take the amortization deduction provided by section 169(a) may, at any time after making such election and prior to the expiration of the 60-month amortization period, elect to discontinue the amortization deduction for the remainder of the 60-month period in the manner prescribed in paragraph (b)(1) of § 1.169-4. In addition, if on or before May 18, 1971, an election under section 169(a) has been made, consent is hereby given to revoke such election without the consent of the Commissioner in the manner prescribed in (b) (2) of § 1.169-4.

(2) *Amount of deduction.* With respect to each month of such 60-month period which falls within the taxable year, the amortization deduction shall be an amount equal to the amortizable basis of the certified pollution control facility at the end of such month divided by the number of months (including the month for which the deduction is computed) remaining in such 60-month period. The amortizable basis at the end of any month shall be computed without regard to the amortization deduction for such month. The total amortization deduction with respect to a certified pollution control facility for a taxable year is the sum of the amortization deductions allowable for each month of the 60-month period which falls within such taxable year. If a certified pollution control facility is sold or exchanged or otherwise disposed of during 1 month, the amortization deduction (if any) allowable to the original holder in respect of such month shall be that portion of the amount to which such person would be entitled for a full month which the number of days in such month during which the facility was held by such person bears to the total number of days in such month.

(3) *Effect on other deductions.* (i) The amortization deduction provided by section 169 with respect to any month shall be in lieu of the depreciation deduction which would otherwise be allowable under section 167 or a deduction in lieu of depreciation which would otherwise be allowable under paragraph (b) of § 1.162-11 for such month.

(ii) If the adjusted basis of such facility as computed under section 1011 for purposes other than the amortization deduction provided by section 169 is in excess of the amortizable basis, as computed under § 1.169-3, such excess shall be recovered through depreciation deductions under the rules of section 167. See section 169(g).

(iii) See section 179 and paragraph (e) (1) (ii) of § 1.179-1 and paragraph (b) (2) of § 1.169-3 for additional first-year depreciation in respect of a certified pollution control facility.

(4) [Reserved]

(5) *Special rules.* (i) In the case of a certified pollution control facility held by one person for life with the remainder to another person, the amortization deduction under section 169(a) shall be computed as if the life tenant were the absolute owner of the property and shall be allowable to the life tenant during his life.

(ii) If the assets of a corporation which has elected to take the amortization deduction under section 169(a) are acquired by another corporation in a transaction to which section 381 (relating to carryovers in certain corporate acquisitions) applies, the acquiring corporation is to be treated as if it were the distributor or transferor corporation for purposes of this section.

(iii) For the right of estates and trusts to amortize pollution control facilities see section 642(f) and § 1.642 (f)-1. For the allowance of the amortization deduction in the case of pollution control facilities of partnerships, see section 703 and § 1.703-1.

(6) *Depreciation subsequent to discontinuance or in the case of revocation of amortization.* A taxpayer which elects in the manner prescribed under paragraph (b) (1) of § 1.169-4 to discontinue amortization deductions or under paragraph (b) (2) of § 1.169-4 to revoke an election under section 169(a) with respect to a certified pollution control facility is entitled, if such facility is of a character subject to the allowance for depreciation provided in section 167, to a deduction for depreciation (to the extent allowable) with respect to such facility. In the case of an election to discontinue an amortization deduction, the deduction for depreciation shall begin with the first month as to which such amortization deduction is not applicable and shall be computed on the adjusted basis of the property as of the beginning of such month (see section 1011 and the regulations thereunder). Such depreciation deduction shall be based upon the remaining portion of the period authorized under section 167 for the facility as determined, as of the first day of the first month as of which the amortization deduction is not applicable. If the taxpayer so elects to discontinue the amortization deduction under section 169(a), such taxpayer shall not be entitled to any further amortization deduction under this section and section 169(a) with respect to such pollution control facility. In the case of a revocation of an election under section 169(a), the deduction for depreciation shall begin as of the time such depreciation deduction would have been taken but for the election under section 169(a). See paragraph (b)(2) of § 1.169-4 for rules as to filing amended returns for years for which amortization deductions have been taken.

(7) *Definitions.* Except as otherwise provided in § 1.169-2, all terms used in section 169 and the regulations thereunder shall have the meaning provided by this section and §§ 1.169-2 through 1.169-4.

(b) *Examples.* This section may be illustrated by the following examples:

Example (1). On September 30, 1970, the X Corporation, which uses the calendar year as its taxable year, completes the installation of a facility all of which qualifies as a certified pollution control facility within the meaning of paragraph (a) of § 1.169-2. The cost of the facility is $120,000 and the period referred to in paragraph (a)(6) of § 1.169-2 is 10 years in accordance with the rules set forth in paragraph (a) of § 1.169-4, on its income tax return filed for 1970, X elects to take amortization deduc-

tions under section 169(a) with respect to the facility and to begin the 60-month amortization period with October 1970, the month following the month in which it was completed. The amortizable basis at the end of October 1970 (determined without regard to the amortization deduction under section 169(a) for that month) is $120,000. The allowable amortization deduction with respect to such facility for the taxable year 1970 is $6,000, computed as follows:

Monthly amortization deductions	
October: $120,000 divided by 60	$2,000
November: $118,000 (that is, $120,000 minus $2,000) divided by 59	2,000
December: $116,000 (that is, $118,000 minus $2,000) divided by 58	2,000
Total amortization deduction for 1970	6,000

Example (2). Assume the same facts as in example (1). Assume further that on May 20, 1972, X properly files notice of its election to discontinue the amortization deductions with the month of June 1972. The adjusted basis of the facility as of June 1, 1972, is $80,000, computed as follows:

Yearly amortization deductions	
1970 (as computed in example (1))	$6,000
1971 (computed in accordance with example (1))	24,000
1972 (for the first 5 months of 1972 computed in accordance with example (1))	10,000
Total amortization deductions for 20 months	40,000
Adjusted basis as beginning of amortization period	120,000
Less: Amortization deductions	40,000
Adjusted basis as of June 1, 1972	80,000

Beginning as of June 1, 1972, the deduction for depreciation under section 167 is allowable with respect to the property on its adjusted basis of $80,000.

[T.D. 7116, 36 FR 9012, May 18, 1971; 36 FR 9770, May 28, 1971, as amended by T.D. 7203, 37 FR 17133, Aug. 25, 1972]

§ 1.169-2 Definitions.

(a) *Certified pollution control facility*—(1) *In general.* Under section 169(d), the term "certified pollution control facility" means a facility which—

(i) The Federal certifying authority certifies, in accordance with the rules prescribed in paragraph (c) of this section, is a "treatment facility" described in subparagraph (2) of this paragraph, and

(ii) Is "a new identifiable facility" (as defined in paragraph (b) of this section).

For profitmaking abatement works limitation, see paragraph (d) of this section.

(2) *Treatment facility.* For purposes of subparagraph (1) (i) of this paragraph, a "treatment facility" is a facility which (i) is used to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, or storing of pollutants, contaminants, wastes, or heat and (ii) is used in connection with a plant or other property in operation before January 1, 1969. Determinations under subdivision (i) of this subparagraph shall be made solely by the Federal certifying authority. See subparagraph (3) of this paragraph. For meaning of the phrases "plant or other property" and "in operation before January 1, 1969," see subparagraphs (4) and (5), respectively, of this paragraph.

(3) *Facilities performing multiple functions or used in connection with several plants, etc.* (i) If a facility is designed to perform or does perform a function in addition to abating or controlling water or atmospheric pollution or contamination by removing, altering, disposing or storing pollutants, contaminants, wastes, or heat, such facility shall be a treatment facility only with respect to that part of the cost thereof which is certified by the Federal certifying authority as attributable to abating of controlling water or atmospheric pollution or contamination. For example, if a machine which performs a function in addition to abating water pollution is installed at a cost of $100,000 in, and is used only in connection with, a plant which was in operation before January 1, 1969, and if the Federal certifying authority certifies that $30,000 of the cost of such machine is allocable to its function of abating water pollution, such $30,000 will be deemed to be the adjusted basis for purposes of determining gain for purposes of paragraph (a) of § 1.169-3.

(ii) If a facility is used in connection with more than one plant or other property, and at least one such plant or other property was not in operation before January 1, 1969, such facility shall be a treatment facility only to the extent of that part of the cost

thereof certified by the Federal certifying authority as attributable to abating or controlling water or atmospheric pollution in connection with plants or other property in operation before January 1, 1969. For example, if a machine is constructed after December 31, 1968, at a cost of $100,000 and is used in connection with a number of plants only some of which were in operation before January 1, 1969, and if the Federal certifying authority certifies that $20,000 of the cost of such machine is allocable to its function of abating or controlling water pollution in connection with the plants or other property in operation before January 1, 1969, such $20,000 will be deemed to be the adjusted basis for purposes of determining gain for purposes of paragraph (a) of § 1.169-3. In a case in which the Federal certifying authority certifies the percentage of a facility which is used in connection with plants or other property in operation before January 1, 1969, the adjusted basis for the purposes of determining gain for purposes of paragraph (a) of § 1.169-3 of the portion of the facility so used shall be the adjusted basis for determining gain of the entire facility multiplied by such percentage.

(4) *Plant or other property.* As used in subparagraph (2) of this paragraph, the phrase "plant or other property" means any tangible property whether or not such property is used in the trade or business or held for the production of income. Such term includes, for example, a papermill, a motor vehicle, or a furnace in an apartment house.

(5) *In operation before January 1, 1969.* (i) For purposes of subparagraph (2) of this paragraph and section 169 (d), a plant or other property will be considered to be in operation before January 1, 1969, if prior to that date such plant or other property was actually performing the function for which it was constructed or acquired. For example, a papermill which is completed in July 1968, but which is not actually used to produce paper until 1969 would not be considered to be in operation before January 1, 1969. The fact that such plant or other property was only operating at partial capacity prior to January 1, 1969, or was being used as a standby facility prior to such date, shall not prevent its being considered to be in operation before such date.

(ii) (*a*) A piece of machinery which replaces one which was in operation prior to January 1, 1969, and which was a part of the manufacturing operation carried on by the plant but which does not substantially increase the capacity of the plant will be considered to be in operation prior to January 1, 1969. However, an additional machine that is added to a plant which was in operation before January 1, 1969, and which represents a substantial increase in the plant's capacity will not be considered to have been in operation before such date. There shall be deemed to be a substantial increase in the capacity of a plant or other property as of the time its capacity exceeds by more than 20 percent its capacity on December 31, 1968.

(*b*) In addition, if the total replacements of equipment in any single taxable year beginning after December 31, 1968, represents the replacement of a substantial portion of a manufacturing plant which had been in operation before such date, such replacement shall be considered to result in a new plant which was not in operation before such date. Thus, if a substantial portion of a plant which was in existence before January 1, 1969, is subsequently destroyed by fire and such substantial portion is replaced in a taxable year beginning after that date, such replacement property shall not be considered to have been in operation before January 1, 1969. The replacement of a substantial portion of a plant or other property shall be deemed to have occurred if, during a single taxable year, the taxpayer replaces manufacturing or production facilities or equipment which comprises such plant or other property and which has an adjusted basis (determined without regard to the adjustments provided in section 1016(a) (2) and (3)) in excess of 20 percent of the adjusted basis (so determined) of such plant or other property determined as of the first day of such taxable year.

(6) *Useful life.* For purposes of section 169 and the regulations thereunder, the terms "useful life" and "actual useful life" shall mean the shortest period authorized under section 167 and the regulations thereunder if an election were not made under section 169.

(b) *New identifiable facility*—(1) *In general.* For purposes of paragraph (a)(1)(ii) of this section, the term "new identifiable facility" includes only tangible property (not including a building and its structural components referred to in subparagraph (2) (i) of this paragraph, other than a building and its structural components which under subparagraph (2) (ii) of this paragraph is exclusively a treatment facility) which—

(i) Is of a character subject to the allowance for depreciation provided in section 167,

(ii) (*a*) Is property the construction, reconstruction, or erection (as defined in subparagraph (2) (iii) of this paragraph) of which is completed by the taxpayer after December 31, 1968, or

(*b*) Is property acquired by the taxpayer after December 31, 1968, if the original use of the property commences with the taxpayer and commences after such date (see subparagraph (2) (iii) of this paragraph), and

(iii) Is placed in service (as defined in subparagraph (2) (v) of this paragraph) prior to January 1, 1975.

(2) *Meaning of terms.* (i) For purposes of subparagraph (1) of this paragraph, the terms "building" and "structural component" shall be construed in a manner consistent with the principles set forth in paragraph (e) of § 1.48-1. Thus, for example, the following rules are applicable:

(*a*) The term "building" generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. Such term includes any such structure constructed by, or for, a lessee even if such structure must be removed, or ownership of such structure reverts to the lessor, at the termination of the lease. Such term does not include (*1*) a structure which is essentially an item of machinery or equipment, or (*2*) an enclosure which is so closely combined with the machinery or equipment which it supports, houses, or serves that it must be replaced, retired, or abandoned contemporaneously with such machinery or equipment, and which is depreciated over the life of such machinery or equipment. Thus, the term "building" does not include such structures as oil and gas storage tanks, grain storage bins, silos, fractioning towers, blast furnaces, coke ovens, brick kilns, and coal tipples.

(*b*) The term "structural components" includes, for example, chimneys, and other components relating to the operating or maintenance of a building. However, the term "structural components" does not include machinery or a device which serves no function other than the abatement or control of water or atmospheric pollution.

(ii) For purposes of subparagraph (1) of this paragraph, a building and its structural components will be considered to be exclusively a treatment facility if its only function is the abatement or control of air or water pollution. However, the incidental recovery of profits from wastes or otherwise shall not be deemed to be a function other than the abatement or control of air or water pollution. A building and its structural components which serve no function other than the treatment of wastes will be considered to be exclusively a treatment facility even if it contains areas for employees to operate the treatment facility, rest rooms for such workers, and an office for the management of such treatment facility. However, for example, if a portion of a building is used for the treatment of sewage and another portion of the building is used for the manufacture of machinery, the building is not exclusively a treatment facility. The Federal certifying authority will not certify as to what is a building and its structural components within the meaning of subdivision (i) of this subparagraph.

(iii) For purposes of subparagraph (1)(ii) (*a*) and (*b*) of this paragraph (relating to construction, reconstruction, or erection after December 31, 1968, and original use after December 31, 1968) and paragraph (b)(1) of § 1.169-3 (relating to definition of amortizable basis), the principles set forth in paragraph (a) (1) and (2) of § 1.167(c)-1 and in paragraphs (b) and (c) of § 1.48-2 shall be applied. Thus, for example, the following rules are applicable:

(*a*) Property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications.

(*b*) The portion of the basis of property attributable to construction, reconstruction, or erection after December 31, 1968, consists of all costs of construction, reconstruction, or erection allocable to the period after December 31, 1968, including the cost or other basis of materials entering into such work (but not including, in the case of reconstruction of property, the adjusted basis of the property as of the time such reconstruction is commenced).

(*c*) It is not necessary that materials entering into construction, reconstruction or erection be acquired after December 31, 1968, or that they be new in use.

(*d*) If construction or erection by the taxpayer began after December 31, 1968, the entire cost or other basis of such construction or erection may be taken into account for purposes of determining the amortizable basis under section 169.

(*e*) Construction, reconstruction, or erection by the taxpayer begins when physical work is started on such construction, reconstruction, or erection.

(*f*) Property shall be deemed to be acquired when reduced to physical possession or control.

(*g*) The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. For example, a reconditioned or rebuilt machine acquired by the taxpayer after December 31, 1968, for pollution control purposes will not be treated as being put to original use by the taxpayer regardless of whether it was used for purposes other than pollution control by its previous owner. Whether property is reconditioned or rebuilt property is a question of fact. Property will not be treated as reconditioned or rebuilt merely because it contains some used parts.

(iv) For purposes of subparagraph (1) (iii) of this paragraph (relating to property placed in service prior to January 1, 1975), the principles set forth in paragraph (d) of § 1.46-3 are applicable. Thus, property shall be considered placed in service in the earlier of the following taxable years:

(*a*) The taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins or would have begun; or

(*b*) The taxable year in which the property is placed in a condition or state of readiness and availability for the abatement or control of water or atmospheric pollution.

Thus, if property meets the conditions of (*b*) of this subdivision in a taxable year, it shall be considered placed in service in such year notwithstanding that the period for depreciation with respect to such property begins or would have begun in a succeeding taxable year because, for example, under the taxpayer's depreciation practice such property is or would have been accounted for in a multiple asset account and depreciation is or would have been computed under an "averaging convention" (§ 1.167(a)-10), or depreciation with respect to such property would have been computed under the completed contract method, the unit of production method, or the retirement method. In the case of property acquired by a taxpayer for use in his trade or business (or in the production of income), property shall be considered in a condition or state of readiness and availability for the abatement or control of water or atmospheric pollution if, for example, equipment is acquired for the abatement or control of water or atmospheric pollution and is operational but is undergoing testing to eliminate any defects. However, materials and parts acquired to be used in the construction of an

item of equipment shall not be considered in a condition or state of readiness and availability for the abatement or control of water or atmospheric pollution.

(c) *Certification*—(1) *In general.* For purposes of paragraph (a)(1) of this section, a facility is certified in accordance with the rules prescribed in this paragraph if—

(i) The State certifying authority (as defined in subparagraph (2) of this paragraph) having jurisdiction with respect to such facility has certified to the Federal certifying authority (as defined in subparagraph (3) of this paragraph) that the facility was constructed, reconstructed, erected, or acquired in conformity with the State program or requirements for the abatement or control of water or atmospheric pollution or contamination applicable at the time of such certification, and

(ii) The Federal certifying authority has certified such facility to the Secretary or his delegate as (*a*) being in compliance with the applicable regulations of Federal agencies (such as, for example, the Atomic Energy Commission's regulations pertaining to radiological discharge (10 CFR Part 20)) and (*b*) being in furtherance of the general policy of the United States for cooperation with the States in the prevention and abatement of water pollution under the Federal Water Pollution Control Act, as amended (33 U.S.C. 1151-1175) or in the prevention and abatement of atmospheric pollution and contamination under the Clean Air Act, as amended (42 U.S.C. 1857 et seq.).

(2) *State certifying authority.* The term "state certifying authority" means—

(i) In the case of water pollution, the State water pollution control agency as defined in section 23(a) of the Federal Water Pollution Control Act, as amended (33 U.S.C. 1173(a)),

(ii) In the case of air pollution, the air pollution control agency designated pursuant to section 302(b)(1) of the Clean Air Act, as amended (42 U.S.C. 1857h(b)), and

(iii) Any interstate agency authorized to act in place of a certifying authority of a State. See section 23(a) of the Federal Water Pollution Control Act, as amended (33 U.S.C. 1173(b)) and section 302(c) of the Clean Air Act, as amended (42 U.S.C. 1857h(c)).

(3) *Federal certifying authority.* The term "Federal certifying authority" means the Administrator of the Environmental Protection Agency (see Reorganization Plan No. 3 of 1970, 35 FR 15623).

(d) *Profitmaking abatement works, etc.*—(1) *In general.* Section 169(e) provides that the Federal certifying authority shall not certify any property to the extent it appears that by reason of estimated profits to be derived through the recovery of wastes or otherwise in the operation of such property its costs will be recovered over the period referred to in paragraph (a) (6) of this section for such property. The Federal certifying authority need not certify the amount of estimated profits to be derived from such recovery of wastes or otherwise with respect to such facility. Such estimated profits shall be determined pursuant to subparagraph (2) of this paragraph. However, the Federal certifying authority shall certify—

(i) Whether, in connection with any treatment facility so certified, there is potential cost recovery through the recovery of wastes or otherwise, and

(ii) A specific description of the wastes which will be recovered, or the nature of such cost recovery if otherwise than through the recovery of wastes.

For effect on computation of amortizable basis, see paragraph (c) of § 1.169-3.

(2) *Estimated profits.* For purpose of this paragraph, the term "estimated profits" means the estimated gross receipts from the sale of recovered wastes reduced by the sum of the (i) estimated average annual maintenance and operating expenses, including utilities and labor, allocable to that portion of the facility which is certified as a treatment facility pursuant to paragraph (a)(1)(i) of this section which produces the recovered waste from which the gross receipts are derived, and (ii) estimated selling expenses. However, in determining expenses to be subtracted neither depreciation nor

amortization of the facility is to be taken into account. Estimated profits shall not include any estimated savings to the taxpayer by reason of the taxpayer's reuse or recycling of wastes or other items recovered in connection with the operation of the plant or other property served by the treatment facility.

(3) *Special rules.* The estimates of cost recovery required by subparagraph (2) of this paragraph shall be based on the period referred to in paragraph (a) (6) of this section. Such estimates shall be made at the time the election provided for by section 169 is made and shall also be set out in the application for certification made to the Federal certifying authority. There shall be no redetermination of estimated profits due to unanticipated fluctuations in the market price for wastes or other items, to an unanticipated increase or decrease in the costs of extracting them from the gas or liquid released, or to other unanticipated factors or events occurring after certification.

[T.D. 7116, 36 FR 9013, May 18, 1971; 36 FR 9770, May 28, 1971]

§ 1.169-3 Amortizable basis.

(a) *In general.* The amortizable basis of a certified pollution control facility for the purpose of computing the amortization deduction under section 169 is the adjusted basis of such facility for purposes of determining gain (see part II (section 1011 and following) subchapter O, chapter 1 of the Code), as modified by paragraphs (b), (c), and (d) of this section. For the adjusted basis for purposes of determining gain (computed without regard to such modifications) of a facility which performs a function in addition to pollution control, or which is used in connection with more than one plant or other property, or both, see paragraph (a)(3) of § 1.169-2. For rules as to additions and improvements to such a facility, see paragraph (f) of this section.

(b) *Limitation to post-1968 construction, reconstruction, or erection.* (1) If the construction, reconstruction, or erection was begun before January 1, 1969, there shall be included in the amortizable basis only so much of the adjusted basis of such facility for purposes of determining gain (referred to in paragraph (a) of this section) as is properly attributable under the rules set forth in paragraph (b)(2)(iii) of § 1.169-2 to construction, reconstruction, or erection after December 31, 1968. See section 169 (d)(4). For example, assume a certified pollution control facility for which the shortest period authorized under section 167 is 10 years has a cost of $500,000, of which $450,000 is attributable to construction after December 31, 1968. Further, assume such facility does not perform a function in addition to pollution control and is used only in connection with a plant in operation before January 1, 1969. The facility would have an amortizable basis of $450,000 (computed without regard to paragraphs (c) and (d) of this section). For depreciation of the remaining portion ($50,000) of the cost, see section 169(g) and paragraph (a)(3)(ii) of § 1.169-1. For the definition of the term "certified pollution control facility" see paragraph (a) of § 1.169-2.

(2) If the taxpayer elects to begin the 60-month amortization period with the first month of the taxable year succeeding the taxable year in which such facility is completed or acquired and a depreciation deduction is allowable under section 167 (including an additional first-year depreciation allowance under section 179) with respect to the facility for the taxable year in which it is completed or acquired, the amount determined under subparagraph (1) of this paragraph shall be reduced by an amount equal to (i) the amount of such allowable depreciation multiplied by (ii) a fraction the numerator of which is the amount determined under subparagraph (1) of this paragraph, and the denominator of which is its total cost. The additional first-year allowance for depreciation under section 179 will be allowable only for the year in which the facility is completed or acquired and only if the taxpayer elects to begin the amortization deduction under section 169 with the taxable year succeeding the taxable year in which such facility is completed or acquired. See paragraph (e)(1)(ii) of § 1.179-1.

(c) *Modification for profitmaking abatement works, etc.* If it appears

that by reason of estimated profits to be derived through the recovery of wastes or otherwise (as determined by applying the rules prescribed in paragraph (d) of § 1.169-2) a portion or all of the total costs of the certified pollution control facility will be recovered over the period referred to in paragraph (a)(b) of § 1.169-2, its amortizable basis (computed without regard to this paragraph and paragraph (d) of this section) shall be reduced by an amount equal to (1) its amortizable basis (so computed) multiplied by (2) a fraction the numerator of which is such estimated profits and the denominator of which is its adjusted basis for purposes of determining gain. See section 169(e).

(d) *Cases in which the period referred to in paragraph (a)(6) of § 1.169-2 exceeds 15 years.* If as to a certified pollution control facility the period referred to in paragraph (a)(6) of § 1.169-2 exceeds 15 years (determined as of the first day of the first month for which a deduction is allowable under the election made under the section 169(b) and paragraph (a) of § 1.169-4), the amortizable basis of such facility shall be an amount equal to (1) its amortizable basis (computed without regard to this paragraph) multiplied by (2) a fraction the numerator of which is 15 years and the denominator of which is the number of years of such period. See section 169(f)(2)(A).

(e) *Examples.* This section may be illustrated by the following example:

Example (1). The X Corporation, which uses the calendar year as its taxable year, began the installation of a facility on November 1, 1968, and completed the installation on June 30, 1970, at a cost of $400,000. All of the facility qualifies as a certified pollution control facility within the meaning of paragraph (a) of § 1.169-2. $40,000 of such cost is attributable to construction prior to January 1, 1969. The X Corporation elects to take amortization deductions under section 169(a) with respect to the facility and to begin the 60-month amortization period with January 1, 1971. The corporation takes a depreciation deduction under sections 167 and 179 of $10,000 (the amount allowable, of which $2,000 is for additional first year depreciation under section 179) for the last 6 months of 1970. It is estimated that over the period referred to in paragraph (a)(6) of § 1.169-2 (20 years) as to such facility, $80,000 in profits will be realized from the sale of wastes recovered in its operation. The amortizable basis of the facility for purposes of computing the amortization deduction as of January 1, 1971, is $210,600, computed as follows:

(1) Portion of $400,000 cost attributable to post-1968 construction, reconstruction, or erection		$360,000
(2) Reduction for portion of depreciation deduction taken for the taxable year in which the facility was completed:		
(a) $10,000 depreciation deduction taken for last 6 months of 1970 including $2,000 for additional first year depreciation under section 179	$10,000	
(b) Multiplied by the amount in line (1) and divided by the total cost of the facility ($360,000/ $400,000)	0.9	$9,000
(3) Subtotal		$351,000
(4) Modification for profitmaking abatement works: Multiply line (3) by estimated profits through waste recovery ($80,000) and divide by the adjusted basis for determining gain of the facility ($400,000).		
(5) Reduction		$70,200
(6) Subtotal		$280,800
(7) Modification for period referred to in paragraph (a)(6) of § 1.169-2 exceeding 15 years: Multiply by 15 years and divide by such period (determined in accordance with paragraph (d) of this section) (20 years)		0.75
(8) Amortizable basis		$210,600

Example (2). Assume the same faacts as in example (1) except that the facility is used in connection with a number of separate plants some of which were in operation before January 1, 1969, that the Federal certifying authority certifies that 80 percent of the capacity of the facility is allocable to the plants which were in operation before such date, and that all of the waste recovery is allocable to the portion of the facility used in connection with the plants in operation before January 1, 1969. The amortizable basis of such facility, for purposes of computing the amortization deduction as of January 1, 1971, is $157,950 computed as follows:

(1) Adjusted basis for purposes of determining gain: Multiply percent certified as allocable to plants in operation before January 1, 1969 (80 percent) by cost of entire facility ($400,000)	$320,000
(2) Portion of adjusted basis for determining gain attributable to post-1968 construction, reconstruction, or erection: Multiply line (1) by portion of total cost of facility attributable to post-1968 construction, reconstruction, or erection ($360,000) and divide by the total cost of the facility ($400,000)	$288,000

(3) Reduction for portion of depreciation deduction taken for the taxable year in which the facility was completed:		
(a) $10,000 depreciation deduction taken for last 6 months of 1970 including $2,000 for additional first year depreciation under section 170	$10,000	
(b) Multiplied by the amount in line (2) and divided by the total cost of the facility ($288,000/$400,000)	0.72	$7,200
(4) Subtotal		$280,800
(5) Modification for profitmaking abatement works; Multiply line (4) by estimated profits through waste recovery ($80,000) and divide by the amount in line (1) ($320,000).		
(6) Reduction		$70,200
(7) Subtotal		$210,600
(8) Modification for period referred to in paragraph (a)(6) of § 1.169-2 exceeding 15 years: Multiply by 15 years and divide by such period (determined in accordance with paragraph (d) of this section) (20 years)		0.75
(9) Amortizable basis		$157,950

(f) *Additions or improvements.* (1) If after the completion or acquisition of a certified pollution control facility further expenditures are made for additional construction, reconstruction, or improvements, the cost of such additions or improvements made prior to the beginning of the amortization period shall increase the amortizable basis of such facility, but the cost of additions or improvements made after the amortization period has begun, shall not increase the amortizable basis. See section 169(f)(2)(B).

(2) If expenditures for such additional construction, reconstruction, or improvements result in a facility which is new and is separately certified as a certified pollution control facility as defined in section 169(d)(1) and paragraph (a) of § 1.169-2, and, if proper election is made, such expenditures shall be taken into account in computing under paragraph (a) of this section the amortizable basis of such new and separately certified pollution control facility.

[T.D. 7116, 36 FR 9015, May 18, 1971; 36 FR 9770, May 28, 1971]

§ 1.169-4 Time and manner of making elections.

(a) *Election of amortization*—(1) *In general.* Under section 169(b), an election by the taxpayer to take an amortization deduction with respect to a certified pollution control facility and to begin the 60-month amortization period (either with the month following the month in which the facility is completed or acquired, or with the first month of the taxable year succeeding the taxable year in which such facility is completed or acquired) shall be made by a statement to that effect attached to its return for the taxable year in which falls the first month of the 60-month amortization period so elected. Such statement shall include the following information (if not otherwise included in the documents referred to in subdivision (ix) of this subparagraph):

(i) A description clearly identifying each certified pollution control facility for which an amortization deduction is claimed;

(ii) The date on which such facility was completed or acquired (see paragraph (b)(2)(iii) of § 1.169-2);

(iii) The period referred to in paragraph (a)(6) of § 1.169-2 for the facility as of the date the property is placed in service;

(iv) The date as of which the amortization period is to begin;

(v) The date the plant or other property to which the facility is connected began operating (see paragraph (a)(5) of § 1.169-2);

(vi) The total costs and expenditures paid or incurred in the acquisition, construction, and installation of such facility;

(vii) A description of any wastes which the facility will recover during the course of its operation, and a reasonable estimate of the profits which will be realized by the sale of such wastes whether pollutants or otherwise, over the period referred to in paragraph (a)(6) of § 1.169-2 as to the facility. Such estimate shall include a schedule setting forth a detailed computation illustrating how the estimate was arrived at including every element prescribed in the definition of estimated profits in paragraph (d)(2) of § 1.169-2;

(viii) A computation showing the amortizable basis (as defined in § 1.169-3) of the facility as of the first month for which the amortization deduction provided for by section 169(a) is elected; and

(ix)(*a*) A statement that the facility has been certified by the Federal certifying authority, together with a copy of such certification, and a copy of the application for certification which was filed with and approved by the Federal certifying authority of (*b*), if the facility has not been certified by the Federal certifying authority, a statement that application has been made to the proper State certifying authority (see paragraph (c) (2) of § 1.169-2) together with a copy of such application and (except in the case of an election to which subparagraph (4) of this paragraph applies) a copy of the application filed or to be filed with the Federal certifying authority.

If subdivision (ix)(*b*) of this subparagraph applies, within 90 days after receipt by the taxpayer, the certification from the Federal certifying authority shall be filed by the taxpayer with the district director, or with the director of the internal revenue service center, with whom the return referred to in this subparagraph was filed.

(2) *Special rule.* If the return for the taxable year in which falls the first month of the 60-month amortization period to be elected is filed before November 16, 1971, without making the election for such year, then on or before December 31, 1971 (or if there is no State certifying authority in existence on November 16, 1971, on or before the 90th day after such authority is established), the election may be made by a statement attached to an amended income tax return for the taxable year in which falls the first month of the 60-month amortization period so elected. Amended income tax returns or claims for credit or refund must also be filed at this time for other taxable years which are within the amortization period and which are subsequent to the taxable year for which the election is made. Nothing in this paragraph should be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(3) *Other requirements and considerations.* No method of making the election provided for in section 169(a) other than that prescribed in this section shall be permitted on or after May 18, 1971. A taxpayer which does not elect in the manner prescribed in this section to take amortization deductions with respect to a certified pollution control facility shall not be entitled to such deductions. In the case of a taxpayer which elects prior to May 18, 1971, the statement required by subparagraph (1) of this paragraph shall be attached to its income tax return for either its taxable year in which December 31, 1971, occurs or its taxable year preceding such year.

(4) *Elections filed before February 29, 1972.* If a statement of election required by subparagraph (1) of this paragraph is attached to a return (including an amended return referred to in subparagraph (2) of this paragraph) filed before February 29, 1972, such statement of election need not include a copy of the Federal application to be filed with the Federal certifying authority but a copy of such application must be filed no later than February 29, 1972, by the taxpayer with the district director, or with the director of the internal revenue service center, with whom the return or amended return referred to in this subparagraph was filed.

(b) *Election to discontinue or revoke amortization*—(1) *Election to discontinue.* An election to discontinue the amortization deduction provided by section 169(c) and paragraph (a)(1) of § 1.169-1 shall be made by a statement in writing filed with the district director, or with the director of the internal revenue service center, with whom the return of the taxpayer is required to be filed for its taxable year in which falls the first month for which the election terminates. Such statement shall specify the month as of the beginning of which the taxpayer elects to discontinue such deductions. Unless the election to discontinue amortization is one to which subparagraph (2) of this paragraph applies, such statement shall be filed before the beginning of the month specified therein. In addition, such statement shall contain a description clearly identifying the certified pollution control facility with respect to which the taxpayer elects to discontinue the amortization deduction, and, if a certification has previously been issued, a copy of the

certification by the Federal certifying authority. If at the time of such election a certification has not been issued (or if one has been issued it has not been filed as provided in paragraph (a)(1) of this section), the taxpayer shall file, with respect to any taxable year or years for which a deduction under section 169 has been taken, a copy of such certification within 90 days after receipt thereof. For purposes of this paragraph, notification to the Secretary or his delegate from the Federal certifying authority that the facility no longer meets the requirements under which certification was originally granted by the State or Federal certifying authority shall have the same effect as a notice from the taxpayer electing to terminate amortization as of the month following the month such facility ceased functioning in accordance with such requirements.

(2) *Revocation of elections made prior to May 18, 1971.* If on or before May 18, 1971, an election under section 169(a) has been made, such election may be revoked (see paragraph (a)(1) of § 1.169-1) by filing on or before August 16, 1971, a statement of revocation of an election under section 169(a) in accordance with the requirements in subparagraph (1) of this paragraph for filing a notice to discontinue an election. If such election to revoke is for a period which falls within one or more taxable years for which an income tax return has been filed, amended income tax returns shall be filed for any such taxable years in which deductions were taken under section 169 on or before August 16, 1971.

[T.D. 7116, 36 FR 9016, May 18, 1971, as amended by T.D. 7135, 36 FR 14183, July 31, 1971; 36 FR 24995, Dec. 28, 1971]

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FINDING AIDS

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For the period before January 1, 1973, see the "List of CFR Sections Affected, 1949-1963 and 1964-1972," published in three separate volumes.

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1-11-1 (a) revised.....32792
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1.40 Added.....6150
1.40-1 Added.....6150
1.42 Redesignated from 1.39; historical note revised.....6150
1.46-2 (e) revised.....30554
1.50A Added.....6150
1.50-1 Added.....6151
1.50A-2 Added.....6152
1.50A-3 Added.....6153
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1.61-3 (a) revised.....26184
1.79-1 (b)(1)(ii) (*b*) (c) corrected.....2417
1.142-1 (a) revised.....9295
1.152 (b)(3) revised.....33395
1.152-2 (a)(1), (2)(i) and (iii) revised.....33396
1.163-3 (c) heading and (c)(1) revised; (c)(3) added.....4253
1.163-4 (c) revised.....4253
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1.167 (a)-12 Added.....14923
1.167 (m) Added.....9986
1.167 (m)-1 Added.....9986

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1.165-1 (c)(3) revised.....963

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1 Technical correction.....45216
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1.1 Amended.....44215
1.1-1 (a)(1), (b), and (c) revised; (a)(2) amended.....44216
1.72-6 (c)(4) added.....11880
1.116 Amended.....44216
1.116-1 (e)(1) revised.....44216
1.154 Amended.....44216
1.162 (c) (2) and (3) and historical note revised.....†7437
1.162-1 (b)(6) added.....20203
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NOTE: Symbol (†) refers to 1975 page numbers.

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1.167(a)-11 (b)(6)(ii) and (c)(1)(iv)(*a*) amended 20195
(b)(6)(ii) corrected 20681
1.167(a)-12 (a)(4)(iii)(*b*) and (5)(v) amended 20195
1.167(l)-1 Added 20195
1.167(l)-2 Redesignated from 1.167(l)-4 20195
1.167(l)-3 Added 20202
1.167(l)-4 Redesignated as 1.167(l)-2 20195
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1.167(l)-5 Redesignated as 1.167(l)-4 20203

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(Regulations published from April 1, 1975 through March 31, 1976)

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Chapter I
1.1 Amended and historical note revised Δ12639
1.11-1 (c), (d), and (e) revised Δ12639
1.21 (f) added; historical note revised Δ12639
1.21-1 (h)(l) and (n) amended Δ12639
1.44—1.44-5 Added 55850
1.44-2 (a) corrected 58138
1.44-4 (a)(3) corrected 58138
1.62 Amended Δ5099
1.62-1 (c)(12) through (15) added Δ5099
1.72-4 (b)(2) revised 16663
1.72-15 (a) and (d) revised; (f) amended; (i) added 16664
1.101-2 (a)(2) revised 16666
1.103-8 (f)(2)(ii)(*a*) amended; (*d*) revised; (*e*) and (*f*) removed 26028
1.105-4 (a)(2)(i) and (3)(i) revised 16666
1.105-6 Added 16666
1.115-1 (a)(4) revised 49321
1.162-21 (b)(1)(ii) and (2) revised 29290
1.163-1 (d) added Δ9547

NOTE: Symbol (†) refers to 1975 page number.
NOTE: Symbol (Δ) refers to 1976 page number

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(Regulations published from April 1, 1976 through March 31, 1977)

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1.42 Redesignated as 1.45 and amended; note revised; new 1.42 added 14369
1.42-1 Added 14369
1.101 (b)(2)(B)(iii) and note revised 34619
1.101-2 (d)(2) introductory text, (d)(4)(i)(*a*), and (d)(4)(iv) revised; (d)(4)(v) amended 34619
1.165-3 (b)(2) revised 55710
1.166 (g) redesignated as (h) and revised; new (g) added 53480
1.166-4 (d) revised 53481

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(Regulations published from April 1, 1977 through March 31, 1978)

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1.21-1 (n) amended 64694
1.62 Removed 54947
1.62-1 (c)(16) added 54947
1.78-1 (a), (e)(1) and (f) amended 20130
(f) Revised 30497
(f) Corrected 32536
1.103-8 (a)(1)(i) amended 54285
1.103-9 (a)(1) amended 54285
1.103-10 (b)(1)(ii) amended 54285
1.165 Removed 63411
1.165-1 (e) revised 63411
1.165-7 (a)(1) amended 63411
1.165-11 (b) (2) and (3), (c), and (d) revised 63411
1.167(a)-12 (e) (2) and (3) revised 58934

NOTE: Symbol (*) refers to 1977 page numbers
NOTE: Symbol (†) refers to 1978 page numbers.

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1 Determintations Δ17158
1.5 Removed 40466
1.12 Removed 40466
1.41-0 Added Δ18222
1.41-1 Added Δ18222
1.41-2 Added Δ18223
1.41-3 Added Δ18223
1.41-4 Added Δ18223
1.41-5 Added Δ18223
1.41-6 Added Δ18223
1.41-7 Added Δ18223
1.41-8 Added Δ18223
1.42 Removed 19653
1.42-1 Heading revised 19653
1.42A-1 Added 19653
1.43-1 Added 13877
1.46 Removed 40466
Removed Δ17667
1.46-1 (c) revised 40466
1.46-3 (g)(1) and (2) revised; (g)(3), (4), and (5) headings added Δ17667
1.46-6 Added Δ17667
1.46-7 Added Δ4133
1.46-8 Added Δ4135
1.51 Removed 40466
1.52-1 Added 31322
1.52-2 Added 31323
1.52-3 Added 31324
1.53-1 Added 37451
Correctly added 60445
1.56-1 Added 40466
1.56-2 Added 40467
1.56-3 Added 40468
1.56-4 Added 40468
1.56-5 Added 40468
1.57-0 Added 40470
1.57-1 Added 40470
1.57-4 Added 40476
1.57-5 Added 40479
1.58-1 Added 40479
1.58-2 Added 40481
1.58-3 Added 40482
1.58-4 Added 40483
1.58-5 Added 40484
1.58-6 Added 40484
1.58-7 Added 40484
1.58-8 Added 40492
1.61-2 (d)(1), (2), (4), and (5) revised; (d)(6) added Δ31913
1.61-15 (a) revised Δ31913

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1.63 Removed Δ1105
1.63-1 Added Δ1105
1.82-1 (b)(2) amended 59355
1.83-1 Added 31913
1.83-2 Added 31915
1.83-3 Added 31916
1.83-4 Added 31918
1.83-5 Added 31918
1.83-6 Added 31919
1.83-7 Added 31920
1.83-8 Added 31921
1.122 Removed 38819
1.22-1 (a), (b)(2)(iii) (*a*) and (*b*), (c) (1), (3), and (4), and (d) amended; (b)(1) and (d) introductory text revised; (e) added 38819
1.164-1 Undesignated text following (a)(5) revised 59357
1.167(a)-11 (a)(1), (b)(4)(i) and (iii)(*c*), (d)(1)(iii), (2)(iv), (f)(1)(i), and (5) amended; (f)(10(iii), (2), and (4) revised; (f)(6) added Δ5420
(f)(6) corrected Δ14548

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(Regulations published from April 1, 1979 through March 31, 1980)

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1.1 Removed *6088
1.2 Removed *6088
1.3 Removed *6088
1.4 Removed *6088
1.11 Removed *6088
1.21 Removed *6088
1.31 Removed *6088
1.32 Removed *6088
1.33 Removed *6088
1.34 Removed *6088
1.35 Removed *6088
1.36 Removed *6088
1.37 Removed *6088
1.38 Removed 20416
Removed *6088
1.38-1 Revised 20417
1.39 Removed *6088
1.40 Removed *6088
1.43-1 Heading, (a) and (e) revised *16175
1.43-2 added *16175

NOTE: Symbol (Δ) refers to 1979 pages.

NOTE: Symbol (*) refers to 1980 page numbers.

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1.44 Removed *6088
1.44A-1 Added..... 50332
1.44A-2 Added..... 50334
1.44A-3 Added..... 50335
1.44A-4 Added..... 50335
1.45 Removed..... *6088
1.46 Removed..... *6088
1.46-1 Amended..... 47048
1.46-7 Hearing..... 27078
1.46-8 Hearing..... 27078
1.47 Removed..... *6088
1.48 Removed..... 20417
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1.48-8 Added..... 20417
1.49 Removed..... *6088
1.50 Removed..... *6088
1.50A Removed..... *6088
1.50A-(c) revised..... 47049
1.50B Removed..... *6088
1.51 Removed..... *6088
1.61 Removed..... *6088
1.61-2 (d)(2)(ii) (*a*) amended..... 28800
1.71 Removed..... *6088
1.72 Removed..... *6088
1.72-17 (g) added..... 47049
1.72-17A Added..... 47049
1.73 Removed..... *6088
1.74 Removed..... *6088
1.75 Removed..... *6088
1.76 Removed..... *6088
1.77 Removed..... *6088
1.78 Removed..... *6088
1.78-1 Nomenclature change..... *60086
1.79 Removed..... 28797
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1.79-0 Added..... 28797
1.79-1 Revised..... 28798
1.79-2 (b)(4)(ii)(*a*) amended..... 28800
1.79-3 Nomenclature change..... 28800
1.1.82 Removed..... *6088
1.84-1 Added..... *8003
1.101 Removed..... *6088
1.102 Removed..... *6088
1.103 Removed..... *6088
1.103-13 Added..... 32658
1.103-14 Added..... 32669
(e)91)(i)(D) example (3) corrected..... 64405
1.103-15 Added..... 32678
1.104 Removed..... *6088
1.105 Removed..... *6088
1.106 Removed..... *6088
1.107 Removed..... *6088
1.108(a) Removed..... *6088
1.108(b) Removed..... *6088

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1.109 Removed..... *6088
1.110 Removed..... *6088
1.111 Removed..... *6088
1.112 Removed..... *6088
1.113 Removed..... *6088
1.114 Removed..... *6088
1.115 Removed..... *6088
1.116 Removed..... *6088
1.117 Removed..... *6088
1.118 Removed..... *6088
1.119 Removed..... *6088
1.120 Removed..... *6088
1.121 Removed..... 24837
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1.121-1 Revised..... 24839
1.121-2 Revised..... 24840
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1.121-4 Revised..... 24840
1.121-5 Revised..... 24841
1.123 Removed..... *6088
1.124 Removed..... *6088
1.141 Removed..... *6088
1.142 Removed..... *6088
1.143 Removed..... *6088
1.144 Removed..... *6088
1.145 Removed..... *6088
1.151 Removed..... *6088
1.152 Removed..... 48674
Removed..... *6088
1.152-4 (d)(3) revised; (f) amended..... 48674
1.153 Removed..... *6088
1.161 Removed..... *6088
1.162 Removed..... *6088
1.163 Removed..... *6088
1.164 Removed..... *6088
1.166 Removed..... 68465
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1.166-5 (c) revised..... 68464
1.166-8 Heading revised; (d) added..... 68464
1.166-9 Added..... 68464
1.167(a) Removed..... *6088
1.167(b) Removed..... *6088
1.167(c) Removed..... *6088
1.167(d) Removed..... *6088
1.167(e) Removed..... *6088
1.167(f) Removed..... *6088
1.167(g) Removed..... *6088
1.167(h) Removed..... *6088
1.167(i) Removed..... *6088
1.167(j) Removed..... *6088
1.167(k) Removed..... 49448

Note: Symbol (*) refers to 1980 page numbers

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1.167(k)-1 (a)(1) and (2), (b) (1) and (2), (b) (1) and (2) amended; (d) added 49448
1.167(k)-2 (a), (c)(1) and (2) and (e)(1) amended; (e)(2) redesignated as (e)(3); new (e)(2) added 49448
1.167(k)-3 (a)(2) and (b)(1) (i) amended; (b)(2), (3), and (4) revised; (b)(5) redesignated as (b)(7) and amended; new (b)(5) and (6) and (d) added 49449
1.167(k)-4 (f) added 49450
1.167(*l*) Removed *6088
1.167(*m*) Removed *6088
1.168 Removed *6088
1.169 Removed *6088

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1.37 Removed 84049
1.37-1 Revised 84049
1.37-2 Revised 84050
1.37-3 Revised 84050
1.37-4 Removed 84052
1.37-5 Removed 84052
1.44C-1 Added 57715
1.44C-2 Added 57716
1.44C-3 Added 57719
1.44C-5 Added 57721

NOTE: Symbol (*) refers to 1980 page numbers.
NOTE: Symbol (†) refers to 1981 page numbers.

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1.44C-6 Added 57721
1.46 Removed ..... †11262
1.46-1 (a) through (d) revised; (e) redesignated as (o) and amended; (f) redesignated as (p) and (1), (2)(i), (iii), (4), and (5) amended; new (e) through (n) added ..... †1677
1.46-1 (n) corrected ..... †6100
1.46-2 Revised ..... †1679
1.46-4 (b)(2)(ii) amended ..... †11262
1.47-1 (a)(1)(i) amended; (h) added ..... †7291
1.48-9 Added ..... †7291
1.50B-5 (b)(2)(ii) amended ..... †11262
1.61-12 (e) added 81745
1.85-1 Added 46069
1.103-8 Nomenclature changes; (a)(2), (e)(2)(i), and (3) amended; (e)(2) (ii) and (iii) redesignated as (e)(2) (iii) and (iv); new (e)(2) (ii) and (4) added 75645
1.105-11 Added ..... †3505
1.115-1 (d)(2)(iv) amended ..... †11263
1.120-3 Added 28320
1.123-1 (a)(3) amended 72650
1.164-2 (f) amended; (h) added ..... †11263
1.166-2 (a)(2) amended 72650
1.166-9 (c) revised; eff. 4-30-81 ... 86445
1.167(a)-11 (c)(2)(iv) existing text redesignated as (*a*) and (*b*) and amended; (c)(2)(iv) (*c*), (*d*), and (*e*) added; (c)(4) amended ..... †6910